Global Harmonization
National Securities Regulation
Cross-border Capital Markets
Disclosure

FIVE YEAR
REVIEW COMMITTEE
FINAL REPORT

~

REVIEWING THE
SECURITIES ACT
(ONTARIO)

MARCH 21, 2003

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REVIEW COMMITTEE
FINAL REPORT

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LETTER FROM THE COMMITTEE

March 21, 2003

Honourable Janet Ecker
Minister of Finance
7th Floor, Frost Building South
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Toronto, ON
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Dear Minister Ecker:

We are pleased to present to you our Final Report reviewing the Securities Act (Ontario). This Final Report is the culmination of more than two and one-half years of meetings, research and deliberations concerning the current state of securities legislation in Ontario. In May 2002 we published our Draft Report for comment. The comment period concluded in August. We received 45 comment letters; the list of commenters is set out in Appendix B. This Final Report is the result of our deliberations concerning the comments we received on the Draft Report, and our consideration of events subsequent to the date of the Draft Report. The Final Report considers events and legislative reform as of February 28, 2003. A summary of our recommendations is contained in the Executive Summary. A glossary of terms used in the Final Report is found in Appendix A.

Much has happened since the release of our Draft Report. One of the major events was the passage of the 2002 Amendments (formerly Bill 198). We were pleased to see that some of the recommendations contained in our Draft Report were adopted by the Government of Ontario in this legislation.

As you review our Final Report, we draw your attention to our discussions of the following topics:

1. The need for a single, co-ordinated approach to securities regulation in Canada. It is our very strong view that a nation that commands only two per cent of the global economy suffers daily from a regulatory regime which is comprised of 13 separate regulators. Please see our discussion at pages 29-41.

2. The strengthening of the enforcement powers of the Commission. We believe that enhanced powers to impose monetary penalties, and the introduction of anti-fraud and anti-market manipulation rules, will encourage enhanced compliance with Ontario

securities laws.[1] In addition, we believe the court should be able to impose increased fines and/or prison terms where a breach has been proven pursuant to the quasi-criminal provisions in the Act.[2] Please see our discussion at pages 205-254.

3. The need for enhanced regulation of corporate governance and accountability of public companies. Please see our discussion at pages 168-174.
4. Accountability and governance of the Commission. Please see our discussion at pages 61-65.
5. The importance of civil liability for secondary market disclosure by issuers. We support the Government of Ontario's initiative in this regard and encourage other provincial and territorial governments to follow suit.[3] Please see our discussion at pages 129-133.
6. The introduction of a system of governance for mutual funds. Please see our discussion at pages 189-203.
7. How to regulate in an increasingly technological world. The Internet has greatly facilitated communications among people; the challenge for regulators is to determine what public policy considerations are engaged by increasingly sophisticated technologies, and the appropriate regulatory responses. Please see our discussion at pages 88-94.

Certain of our recommendations relate to issues that are already on the agenda of the Commission and/or the CSA, and our recommendations may be considered by the regulators in their current deliberations on these matters. We are also aware of other current initiatives, including the Deregulation Project being undertaken by the BCSC, and the CSA's Uniform Securities Law Project. We suggest that our recommendations be considered in conjunction with these initiatives.

Shortly before our Draft Report was being finalized last spring, Enron Corp., one of the world's largest energy trading, commodities and services companies, collapsed. At that time, the review by regulators and legislators in the U.S. and Canada as to the circumstances surrounding Enron's collapse, focusing in particular on the reliability and transparency of corporate disclosure and the financial reporting process, corporate governance, and auditor independence, was just beginning. While it was unclear what conclusions would emerge from the Enron investigation, we knew that

---

[1] The 2002 Amendments include amendments to the Act that will create express prohibitions against securities fraud, market manipulation and making misleading or untrue statements.

[2] The 2002 Amendments include amendments to the Act that will increase the maximum penalties that can be imposed by a court for offences under section 122 of the Act from a fine of $1 million and imprisonment for two years to a fine of $5 million and imprisonment for five years less a day.

[3] The 2002 Amendments include amendments to the Act that will create a statutory right of action for investors in the secondary market to sue companies and other responsible persons for misrepresentations or failures to make timely disclosure.

Enron had profoundly shaken investor confidence in the integrity of our capital markets. Since that time, a number of other significant events have occurred:

1. Other corporate disasters of similar proportion have occurred in the U.S., including WorldCom Inc. and Adelphia Communications Corporation.

2. In response to the crisis of investor confidence in U.S. capital markets, the U.S. government enacted the *Sarbanes-Oxley Act* on July 30, 2002. The *Sarbanes-Oxley Act* introduces sweeping changes to U.S. securities laws to provide greater investor protection and to strengthen the integrity of financial reporting by U.S. public companies. The NYSE and NASDAQ have introduced proposed reforms to the corporate governance practices of their listed companies. The SEC is in the midst of extensive rulemaking under directions set out in the *Sarbanes-Oxley Act*.

3. In Canada, a number of regulatory and self-regulatory initiatives have been undertaken.

    - In August 2002, David Brown, Chair of the Commission, wrote to the TSX, the CICA, the LSUC, the chairs of the 10 largest securities firms in the country, and numerous market participants seeking their views on initiatives in the U.S. relating to the *Sarbanes-Oxley Act* and the appropriate Canadian response to such initiatives. His letters and the responses can be found at www.osc.gov.on.ca.
    - In September 2002, the CICA published for comment an Exposure Draft entitled "Independence Standards," which will apply to auditors and other assurance providers.
    - Also in September 2002, the Canadian Public Accountability Board was established. Its mandate is to oversee auditors of public companies and help maintain public confidence in the integrity of financial reporting of Canadian public companies. Its founding Chair is Gordon Thiessen.
    - The Canadian Council of Chief Executives issued a report in September 2002 entitled "Governance, Values and Competitiveness – A Commitment to Leadership," in which they indicate their commitment to playing a leadership role in improving corporate governance practices in Canada.
    - In December 2002, the Government of Ontario passed the 2002 Amendments, which introduce important amendments to the Act, most of which were recommended in our Draft Report.[4] The Act will be amended to:

        (i) introduce a regime of civil liability for secondary market disclosure;

---

[4] None of the amendments contained in the 2002 Amendments have been proclaimed in force. The amendments will come into force on a day to be proclaimed by the Lieutenant Governor.

(ii) increase the maximum penalty which a court can impose for breach of the Act to $5 million and the maximum prison term a court can impose for breach of the Act to five years less one day;

(iii) permit the Commission to impose administrative fines of up to $1 million per contravention of the Act and to order disgorgement of profits made from breaching the Act;

(iv) introduce prohibitions against fraud and market manipulation, and against making misleading statements;

(v) give the Commission the power to make rules relating to audit committees and relating to CEO and CFO certification requirements; and

(vi) enshrine in the Act the concept of continuous disclosure reviews.

- The TSX has issued proposed new disclosure requirements and amended guidelines under its Corporate Governance Policy which will apply to all companies listed on the TSX.

Although it is beyond the scope of our mandate to respond fully to the implications of all of these developments, we have tried where possible to take these events into consideration in finalizing our Report.

We appreciate the opportunity to participate in this important public policy process. We would be pleased to provide any further assistance to the Government of Ontario on these matters.

Sincerely,

Five Year Review Committee

Purdy Crawford, Chair
William Riedl
David Wilson

Carol Hansell
Helen Sinclair
Susan Wolburgh Jenah

EXECUTIVE SUMMARY

INTRODUCTION

Several themes emerged in the course of our deliberations. These themes, described below, are reflected in this Report and our recommendations.

1. Regulation should support clearly identified public policy objectives and be proportionate to the objective. The benefits of regulation (and changes to regulation) must outweigh the costs imposed by it.

2. Canada competes with other jurisdictions around the world for capital and for investment opportunities. Our regulatory regime must be part of our competitive advantage. This requires that our regulators be able to operate efficiently and that our regulatory requirements not be more onerous than those existing in other jurisdictions (particularly the U.S.), except as may be required to satisfy our public policy objectives. It also requires that the markets have confidence in the enforcement powers of our regulators and that our regulators have the resources necessary to exercise those powers.

3. Increased harmonization of securities regulation nationally and internationally is imperative to ensure that Canadian capital markets are competitive with other jurisdictions.

4. Securities regulation must be flexible enough to allow regulators to react to changing circumstances on a timely basis.

5. Securities regulation in Canada must be sensitive to the nature of our capital markets and the participants who inhabit it, the large proportion of small cap issuers, and the significant number of public companies with controlling shareholders. In other words, a "one size fits all" approach may not work in all instances in Canada.

The recommendations resulting from our deliberations are set out below, along with a reference to the page of the Report on which the particular recommendation can be found. You will find it helpful also to consider the reasons for each recommendation, which are set out in the part of the Report accompanying the recommendation.

RECOMMENDATIONS PAGE

PART 1 – THE ROLE OF THE COMMISSION IN CAPITAL MARKETS REGULATION

1. We recommend that the provinces, territories and federal government work towards the creation of a single securities regulator with responsibility for the capital markets across Canada. To this end, we strongly encourage the Government of Ontario to actively support the Wise Persons' Committee recently established by the Federal Finance Minister. 41

2. In the meantime, we recommend that certain steps be undertaken by securities regulators to simplify the current regulatory regime in Canada: (i) We recommend that securities regulators continue to harmonize securities regulation across Canada; (ii) We recommend that securities regulators be given the authority to delegate any power, duty, function or responsibility conferred on them to another securities regulatory authority within Canada, and that they actively engage in delegation among themselves. We therefore recommend the Act be amended to give the Commission this delegation authority, and that the necessary consequential amendments to the immunity provisions in the Act be made; (iii) We recommend that securities legislation across the country be amended to provide for "mutual recognition" so that the rules of the jurisdiction having the closest connection to a transaction or market participant will govern that transaction or market participant, and other affected jurisdictions will recognize and allow those rules to be applied in place of their own. 41

3. We strongly encourage the move by both Canadian regulators and standard setters to International Accounting Standards and hope that Canada will continue to play a role in this area – with the ultimate goal of permitting both domestic and foreign issuers to report under IAS without a reconciliation to Canadian GAAP. 48

4. We recommend that the Commission and the CSA permit both foreign and Canadian companies to prepare their financial statements in accordance with U.S. GAAP. Issuers who prepare their financial statements in accordance with U.S. GAAP should be required to reconcile the statements to Canadian GAAP during a transitional period. The duration of the transitional period should be determined by the regulators taking into account whether significant comparability issues will arise if no reconciliation is provided. 48

5. We strongly encourage the Commission and the CSA to continue developing securities transfer legislation modelled on revised Article 8 of the Uniform Commercial Code in the U.S. and we urge governments across Canada to ensure that such legislation is adopted on a uniform basis as soon as possible. 50

RECOMMENDATIONS **PAGE**

6. We encourage the Commission to continue its ongoing participation in IOSCO initiatives and urge the Commission to adopt, in a timely fashion, changes to its rules to implement the international standards emanating from IOSCO. 51

7. We recommend that the CSA, provincial and territorial governments and the federal government move to adopt a system of harmonized functional regulation across Canada, whereby all Canadian capital market activities, products and conduct are regulated in a similar fashion and are subject to similar standards despite the differences between the various institutions or market participants offering the products or services to the marketplace. In the interim, we encourage continued regulatory co-operation and co-ordination in the financial services area through participation in endeavours such as the Joint Forum of Financial Regulators. 58

PART 2 – FLEXIBLE REGULATION

8. We recommend that the Minister of Finance and the Commission consider whether studies of specific aspects of the Commission's operations, similar to those conducted of the SEC by the General Accounting Office in the U.S., should be undertaken. 63

9. We recommend that the current structure of the Commission as a multi-functional agency be given further thought and study by the Commission and the Minister on a priority basis. 65

10. We recommend that section 2.1 of the Act be amended to include the following additional principles to be considered by the Commission in pursuing the purposes of the Act: 69
    - Effective and responsive securities regulation should promote the informed participation of investors in the capital markets.
    - Capital markets are international in character and it is desirable to maintain the competitive position of Ontario's capital markets.
    - Innovation in Ontario's capital markets should be facilitated.
    - The administration and enforcement of Ontario securities law should not unnecessarily impede or distort competition among persons carrying on regulated activities.

11. We recommend that the Act be amended to the extent necessary to ensure that the basic principles relevant to securities legislation are contained in the Act. 72

RECOMMENDATIONS **PAGE**

12. We recommend that the Commission, together with the Government of Ontario, seek to streamline the Act by incorporating detailed requirements in the rules. In addition, we believe that the Act should accurately reflect current law. This may result in certain exemptions being removed from the Act altogether where they have been superseded by a rule. 72

13. We recommend that the Act be amended to give the Commission "basket" rulemaking authority that is substantially identical to that conferred on the Lieutenant Governor in Council pursuant to clause 143(2)(b) of the Act. The Commission should be given the authority to make rules respecting any matter that is "necessary or advisable for carrying out the purposes of the Act." 76

14. We recommend that the Minister indicate the names of commenters who have raised concerns about a particular proposed rule during the Ministerial review period and the nature of the concerns raised. This, in turn, will permit the Commission to satisfy its statutory obligation to make public the fact that a rule has been rejected or returned by the Minister and why. 78

15. We recommend that the Act be amended to require that the Commission republish for comment a proposed rule where the Commission proposes material changes to the rule, having regard to: 80

    (a) the nature of the changes proposed to the rule as a whole; and

    (b) whether the final rule is a logical outgrowth of the rulemaking process when viewed in light of the original rule proposal and request for comments.

    We further recommend that a similar test be adopted for republication of proposed policies.

16. We recommend that the Commission publish black-lined versions of its rules and policies when (i) making changes to existing rules and policies; and (ii) republishing for comment a proposed rule or policy. 80

17. We recommend that the Commission limit the number of projects that it takes on and focus its resources on fewer critical policy issues. We further recommend that the Commission streamline its internal rulemaking process by establishing internal standards for the development of rule and policy proposals, including benchmark timeframes for reviewing and responding to comments on a rule or policy proposal. We recommend that the Commission publish these internal standards and report on its performance against such standards. 81

RECOMMENDATIONS	PAGE
18. In order to enhance the timely implementation of policy changes, we encourage the Commission and the CSA to be willing to adopt practical, if not perfect, solutions.	81
19. When the Commission is conducting cost-benefit analyses of proposed rules, as required under the Act, we recommend that the Commission conduct or commission empirical studies to assess the effectiveness, costs and benefits of the proposed rule.	83
20. We recommend that each cost-benefit analysis which the Commission conducts concerning a proposed rule should specify whether a proposed rule contributes to harmonizing securities laws across Canada and should discuss the expected effect of the new rule on harmonization and co-operation. If adoption of the new rule is expected to lessen harmonization or co-operation, the Commission should describe why it should nevertheless be adopted.	83
21. We recommend that the Act be amended to allow the Commission to issue blanket rulings and orders that provide exemptive relief only.	85
22. We recommend that the Commission publish exemption orders granted from the requirements of securities rules. We also recommend that the Commission provide notice when applications for exemptive relief are not granted, and of the reason for the refusal, subject to keeping the name of the applicant confidential.	86
23. We recommend that the Act be amended to require that future review committees be appointed five years after the date of delivery of the final report of the previous committee. We also recommend that Committee membership represent a diversity of backgrounds and interests relevant to the capital markets.	87
24. We recommend that the CSA consider whether NP 11-201 *Electronic Delivery of Documents* and NP 47-201 *Trading Securities Using the Internet and Other Electronic Means* conflict with provincial legislation such as the ECA. We believe that the CSA should ensure that its guidance continues to be relevant and should issue a communiqué to market participants setting out its views.	90
25. In light of investor protection concerns, we believe that it would not be prudent to eliminate the need for dealer registrant involvement in Internet offerings.	92

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26. The CSA should monitor the success of the limited form of access-equals-delivery contemplated by proposed National Instrument 51-102 *Continuous Disclosure Obligations* with a view to determining whether the access-equals-delivery model can be expanded to encompass additional documents which securities legislation requires be delivered to investors. 94

PART 3 – REGULATION OF MARKET PARTICIPANTS

27. We recommend that the registration requirement relating to trading in securities should be moved to a model requiring the person or company to be "in the business" of trading. However, we would only support such a change if it were to be adopted across the country. 100

28. We believe that the Act should continue to distinguish between the requirement to be registered to advise concerning securities and the requirement to be registered to trade in securities (or, as we propose in our earlier recommendation, to be in the business of trading in securities). However, we recommend that the Commission and CSA carefully review the proficiency, experience and suitability requirements applicable to dealers and employees to ensure that they are sufficiently flexible to permit various models for delivering advice while at the same time ensuring that they are sufficiently rigorous to match the increasingly important role of "incidental advice" provided by dealers and salespersons. 102

29. We encourage the Commission, together with the CSA, to continue to monitor the use of financial portals by market participants, and to facilitate their development where appropriate. Where portals conduct activity in violation of the requirements of the Act, regulators can address this conduct through enforcement proceedings where appropriate. 105

30. We recommend that securities legislation in the provinces be amended to provide consistent substantive registration requirements across the country. We further recommend that the NRD be modified following its launch to permit investors to access relevant information about registrants, including industry experience, any previous disciplinary proceedings to which the registrant was subject, and the products which the registrant is licensed to sell. 106

31. We recommend the Act be amended to eliminate the universal registration requirements. 107

32. We recommend that the Act be amended to authorize the Commission to require SROs to apply for recognition where an SRO is taking on activities which are properly discharged by, or subject to the oversight of, the Commission if the SRO has not otherwise applied to be recognized. 110

RECOMMENDATIONS **PAGE**

33. We recommend that clearing agencies should be required to obtain recognition through an amendment to section 21.2 of the Act to provide that "No person or company shall carry on business as a clearing agency unless recognized by the Commission." We also recommend that the Commission re-examine the definition of "clearing agency" in section 1(1) of the Act to ensure that it properly captures the activities which should trigger the requirement to be recognized. In this regard, we suggest that consideration be given to the definition of "clearing agency" under U.S. legislation. 111

34. We recommend that the Commission and the CSA consider whether to require quotation and trade reporting systems to obtain recognition under securities legislation and to develop a harmonized approach to quotation and trade reporting systems, including re-examining the current definition of a quotation and trade reporting system in the Act. 113

35. We believe that the Canadian Unlisted Board merits regulatory review and urge the Commission to complete its review of the Canadian Unlisted Board as soon as possible, focusing particular attention on concerns relating to transparency and reducing the Canadian Unlisted Board's exposure to abuse. 114

36. We recommend that the Commission study whether the Act should be amended to give SROs the following statutory powers: 116

- jurisdiction over current and former members or "regulated persons" and their current and former directors, officers, partners and employees;
- the ability to compel witnesses to attend and to produce documents at disciplinary hearings;
- the ability to file decisions of disciplinary panels as decisions of the court;
- statutory immunity for SROs and their staff from civil liability arising from acts done in good faith in the conduct of their regulatory responsibilities; and
- the power to seek a court-ordered "monitor" for firms that are in chronic and systemic non-compliance, close to insolvency or for other appropriate public interest criteria.

In considering these issues, the Commission should consider what checks and balances, if any, are necessary to ensure procedural fairness and protections are available to those who will be subject to the new statutory powers.

37. We recommend that stock exchanges and recognized SROs be required to report to the Commission any breaches or possible breaches of securities law that they believe have occurred or may have occurred. 117

RECOMMENDATIONS PAGE

38. We recommend that the IDA consider whether improvements can be made to certain of its structures, such as the composition of its disciplinary panels and the membership of its board of directors, to lessen perceptions of conflict of interest in self-regulation. 120

PART 4 – REGULATING ISSUERS: DISCLOSURE, THE CLOSED SYSTEM AND CORPORATE GOVERNANCE

39. We strongly support the CSA's initiative to harmonize Canadian continuous disclosure requirements and encourage the CSA to assign a high priority to this proposal to ensure its timely adoption across Canada. 129

40. We support the CSA proposal to create a statutory civil liability regime for continuous disclosure and urge the Government of Ontario to move forward as soon as possible to proclaim the legislation in force. We also encourage the governments of the other CSA jurisdictions to adopt the same regime. 133

41. We recommend that the Commission study the appropriateness of amending the existing primary offering civil liability regime to parallel the civil liability regime for continuous disclosure in the following areas: 133

    - changing the joint and several liability scheme to a proportionate liability scheme;
    - extending a due diligence defence to the issuer; and
    - introducing a safe harbour for forward-looking information.

42. We encourage the CSA to proceed with further reforms to the prospectus exemptions and the closed system with the goal of harmonizing and simplifying the requirements relating to private placements. 136

43. Once other reforms are implemented, such as civil liability for continuous disclosure, enhanced continuous disclosure standards for all reporting issuers, and a more integrated disclosure system overall, we believe hold periods for securities of reporting issuers could be eliminated without sacrificing investor protection while contributing significantly to more efficient capital markets. 139

44. We believe the need for seasoning periods in the case of reporting issuers should also be revisited with a view to their elimination if the reforms we contemplate in this Report are implemented. 140

45. Hold periods and seasoning periods should continue to apply to non-reporting issuers. 140

RECOMMENDATIONS **PAGE**

46. We recommend the Commission examine the practice whereby control block holders reduce applicable hold periods through the use of derivatives and other monetization structures. 141

47. We recommend that the Act's timely disclosure provisions not be amended to require disclosure of "material information." 147

48. We recommend that the Commission study whether the current definition of "material change" and timely disclosure reporting obligations should be amended to encompass: 147

    - a broader scope of discloseable events;
    - itemized particular company-specific events requiring timely disclosure similar to the SEC's 8-K approach; and
    - a requirement that agreements relating to the reported disclosure be filed as a schedule to the public report.

49. We recommend that the existing materiality standard should be changed for all purposes under securities legislation to a reasonable investor standard which is consistent with the materiality standard in the U.S. 150

50. Except as noted in Recommendation 51, we do not believe that legislative change is required in Ontario to address the issue of selective disclosure and we support the CSA's policy statement and an increased emphasis on enforcement in this area. 154

51. We recommend that the CSA introduce a 24-hour safe harbour for "unintentional" selective disclosures along the lines of the safe harbour that exists in the U.S. under Regulation FD. 154

52. We support the CSA's proposal to reduce the filing period for filing annual financial statements to 90 days after the fiscal year end for senior issuers, and 120 days for junior issuers. We also support the CSA's proposal to reduce the filing period for filing interim financial statements to 45 days after the quarter end for senior issuers, and to maintain the current 60-day deadline for junior issuers. We recommend, however, that the CSA reconsider whether to use the TSX non-exempt company criteria to separate senior issuers from junior issuers. Instead, we recommend that the CSA consider classifying senior issuers as those issuers whose securities are listed on the TSX and junior issuers as those issuers whose securities are listed on the TSX Venture Exchange. 157

53. We recommend that in due course the CSA consider shortening even further the filing deadlines for annual and interim financial statements to 60 and 35 days respectively to parallel recent rule changes made by the SEC. 157

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54. We recommend that Ontario securities legislation be amended to require that quarterly financial statements must be reviewed by the issuer's external auditor. We endorse in principle providing junior issuers with an exemption from this requirement. The nature and scope of the exemption should be determined by the Commission, taking into account the costs and benefits associated with the requirement with particular attention being paid to the type of issuer and the stage of development of the issuer. We also recommend, however, that any issuer subject to an exemption from the requirement should be required to disclose that its quarterly statements have not been reviewed by an external auditor. 158

55. We recommend that Ontario securities law be amended to require that all news releases of reporting issuers must be filed on SEDAR. 161

56. We recommend that the GAAP exemption available to banks and insurance companies in subsection 2(3) of the Regulation to the Act be removed. 163

57. We urge the Commission and the Public Interest and Integrity Committee of the Canadian Institute of Chartered Accountants to adopt auditor independence standards on a priority basis, to proactively monitor ongoing U.S. developments relating to auditor independence and to consider what further reforms are necessary to ensure that Canada does not fall behind international standards. 166

58. We recommend that the Commission adopt amendments to proxy disclosure rules to require public companies to disclose in their proxy statements their expenditures for both audit and non-audit services. Amendments to proxy disclosure rules should be undertaken once the Public Interest and Integrity Committee of the Canadian Institute of Chartered Accountants has finalized its proposed independence standards and should take into account those standards as well as recent proposed SEC rule changes for auditor independence. 166

59. We endorse the recent amendments to the Act that, when proclaimed in force, will give the Commission rulemaking authority to address all aspects of the certification regime recently adopted by the SEC. In this regard, we urge the Government of Ontario to proclaim the rulemaking amendments in force on a timely basis to permit the Commission to embark on rulemaking in this area. 170

	RECOMMENDATIONS	PAGE
60.	We endorse the recent amendment to the Act that, when proclaimed in force, will give the Commission rulemaking authority to prescribe requirements relating to the functioning and responsibilities of audit committees of reporting issuers. We encourage other CSA jurisdictions to give their commissions similar powers, and we urge the CSA to work together on an expedited basis to establish standards for audit committees that will make Canadian audit committees "best in class" internationally. We also encourage the CSA to be sensitive to the needs and resources of small-cap issuers in crafting any rule proposals.	173
61.	We recommend that the Act be amended to give the Commission rulemaking authority over corporate governance matters more generally. For example, we would support giving the Commission rulemaking authority to make rules relating to the composition, functioning and responsibility of boards of directors and nominating and compensation committees.	174
	PART 5 – ENHANCING FUNDAMENTAL SHAREHOLDER RIGHTS	
62.	We support the reforms to the CBCA relating to proxy solicitation. We strongly recommend that Part XIX of the Act be similarly amended to ensure that shareholders are able to communicate with each other in prescribed circumstances without having to file an information circular. We also recommend that the Commission co-ordinate with the provincial government so as to ensure that amendments adopted under the OBCA and the Act are uniform. We further urge the Commission to consider whether it has the authority to incorporate by reference the requirements of another Canadian statute such as the OBCA or CBCA with respect to proxy solicitation, rather than stating the rules explicitly in the Act.	180
63.	We recommend that the Commission, together with the CSA, undertake further study to determine whether amendments to securities law to relax the requirements relating to communications with and among shareholders in the context of a take-over bid should be enacted.	181
64.	Nothing has come to our attention that would support the need to regulate arrangements and take-over bids in an identical fashion. We believe that, as a matter of public policy, parties to commercial transactions should have the freedom to structure transactions to achieve their business purposes as long as these transactions, and the legislation that governs these transactions, are fair to all interested parties.	183
65.	We recommend that the Commission prepare a policy statement setting out guidance as to the factors to consider in determining when, in the context of take-over bid, a poison pill should be terminated.	184

	RECOMMENDATIONS	PAGE
66.	We recommend that the Commission and the CSA introduce a requirement for all publicly offered mutual funds to establish and maintain an independent governance body. When, in the reasonable opinion of the independent directors, the manager has placed its interests ahead of those of unitholders of a mutual fund through self-dealing, conflict of interest transactions or other breach of its fiduciary obligations, this body should have the right either to terminate the manager or to tell the unitholders about the manager's actions and provide unitholders with a period of time within which to redeem their units at no cost.	197
67.	We recommend that the process by which potential directors of mutual fund governance bodies are identified and nominated be expanded so as to include a broader range of potential directors. We further recommend that the majority of directors be independent of the management company. Lastly, the potential liability and defences available to directors of fund governance agencies needs to be settled in the legislation.	199
68.	We believe that the mutual fund governance body should have certain characteristics, including: independence from the manager; a majority of independent directors; the right to retain counsel and other independent advisers; the right to set its compensation and establish the obligation of each member to disclose annually all fees received from the fund and all affiliated funds; and the right to terminate the manager in specified circumstances.	200
69.	We believe that it is important to identify certain fundamental responsibilities of the mutual fund governance body. We believe these responsibilities should include, at a minimum, overseeing the establishment and implementation of policies related to conflict of interest issues; monitoring fees, expenses and their allocation; receiving reports from the manager concerning compliance with investment goals and strategies; reviewing the appointment of the auditor; meeting with the fund's auditor; and approving material contracts.	201
70.	We urge regulators and the mutual fund industry to work together to determine what standards or requirements should be satisfied by mutual fund managers before they are permitted to establish, promote and run a publicly offered mutual fund; who is best positioned to establish those standards or requirements and to monitor compliance with them; and whether registration of mutual fund managers is necessary and justifiable, from a cost-benefit point of view, as a means of imposing and monitoring compliance with the applicable standards or requirements for mutual fund managers.	203

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71. We recommend that subsection 143(31) of the Act be amended, if required, to give the Commission the necessary authority to address mutual fund governance reform through its rulemaking power. 203

PART 6 – ENFORCEMENT

72. We recommend that the Commission provide guidance, in the form of a set of principles or guidelines, setting out the considerations that may be taken into account in determining the appropriate sanction to be applied in the context of administrative proceedings under section 127 of the Act. 217

73. We suggest that consideration be given to whether it would be appropriate for the Commission to have rule-making authority to deal with issues relating to the administration and distribution of money ordered by the Commission to be disgorged. 221

74. We recommend that a new offence be created under section 122 of the Act, for failing to fulfil, or contravening, a written undertaking to the Commission or the Executive Director. We also recommend that the Commission ensure that persons giving written undertakings to the Commission or the Executive Director are made aware that contravening or failing to fulfil such undertakings is an offence. 223

75. We recommend that the Commission monitor the exercise by the Manitoba Securities Commission and the FSA of their respective new restitution powers and consider the practical implications of the exercise of this power, with a view to revisiting in the future whether a power to order restitution would be an appropriate remedy for the Commission. 224

76. We encourage the Commission to consider exercising its discretion, in appropriate cases, to apply to the court under section 128 of the Act for a restitution or compensation order. 225

77. We recommend that consideration be given to the desirability and implications of amending section 128 of the Act to permit investors, in certain circumstances, to apply to the court directly for an order for restitution or compensation. 225

78. We recommend that, as a condition of its recognition of an SRO, the Commission should require the SRO to require its members to participate in and agree to be bound by any national complaint-handling system that is in place, as well as any industry-sponsored dispute resolution program that may be applicable. We favour transparency in connection with such programs and strongly encourage the publication of statistics relating to the use of the programs as well as particulars concerning the outcomes of cases or the resolution of complaints. 228

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79. We encourage the financial services industry to monitor the national complaint-handling system, in particular in the first year of its operation, to ensure that it is working as intended. Assuming that the system is successfully implemented, we recommend that the financial services industry then consider establishing a dispute resolution system on a similar, national basis. 228

80. We strongly encourage SROs that have or may be contemplating alternative dispute resolution programs to, at a minimum, require their members to advise customers of the availability of such programs. 228

81. We recommend that paragraph 127(1)7 of the Act be amended to authorize the Commission to order that a person resign one or more positions that the person holds as a director or officer of an issuer, *registrant or manager of a mutual fund* (changes in italics). 231

82. We recommend that paragraph 127(1)8 of the Act be amended to authorize the Commission to order that: 231

- a person be prohibited from becoming or acting as a director or officer of any issuer, *registrant or manager of a mutual fund*; and
- *a person or company be prohibited from becoming or acting as a manager of a mutual fund or as a promoter fund* (changes in italics).

83. We recommend that a new paragraph be created under subsection 127(1) of the Act, authorizing the Commission to order that a person or company: 233

- comply with or cease contravening:
  (i) Ontario securities law; or
  (ii) a direction, decision, order or ruling made under a by-law, rule or other regulatory instrument or policy of a recognized SRO or exchange.
- comply in the future or take steps to ensure future compliance with Ontario securities law, or a direction, decision, order or ruling made under a by-law, rule or other regulatory instrument or policy of a recognized SRO or exchange.

84. We recommend that paragraph 127(1)2 of the Act be amended to expressly provide that "trading" in securities for purposes of that paragraph includes the purchase of securities. 234

85. We recommend that section 122 of the Act be amended to include a provision permitting the Ontario Court of Justice to make an order, where appropriate, that the defendant compensate or make restitution to persons who have suffered a loss of property as a result of the commission of an offence by the defendant. 239

RECOMMENDATIONS		PAGE
86.	We recommend that the Commission issue a policy statement providing interpretive guidance on the scope of the confidentiality provision in section 16 of the Act and clarifying the process for making an application for disclosure under section 17 of the Act, including the issue of standing to bring such an application.	242
87.	We recommend that once the provisions of the 2002 Amendments are proclaimed into force, the CSA amend subsection 3.1(2) of National Instrument 23-101 *Trading Rules* to provide that the anti-fraud and market manipulation provisions in the Act will apply in Ontario.	245
88.	We recommend that, in appropriate cases, the Commission consider pursuing alternative enforcement mechanisms available under sections 127 and 128 of the Act as a regulatory response to illegal insider trading.	249
89.	We recommend that the Government of Ontario consider amending the Act to broaden existing insider trading civil liability provisions by deleting the privity requirement in section 134 of the Act. We further recommend that consideration be given to including a provision that limits liability under this section to the amount of profit gained or loss avoided by the insider as a result of the transaction or transactions in question. Any such liability should also be reduced by the amount required to be disgorged pursuant to an order by the court, or the Commission, if applicable, in a proceeding relating to the same transaction or transactions.	249
90.	We recommend that the CSA consider further reducing the time period for filing insider reports (from the current requirement to file within 10 days of the date of the trade) once SEDI is operational.	250
91.	We recommend that Ontario securities law be amended to require insiders to report any effective change in, or disposition of, their economic interest in an issuer.	250
92.	We recommend that the issues raised with respect to the continuation of freeze orders under section 126 of the Act be studied further with the benefit of public input. In particular, we suggest the following issues, at a minimum, would require consideration: ◆ whether the Commission or the court should authorize the continuation of a freeze order; and ◆ what is the appropriate test to be applied in determining whether to continue a freeze order.	252

	RECOMMENDATIONS	PAGE
93.	With respect to the current power to order costs under section 127.1 of the Act, we recommend that the Commission develop policies or guidelines regarding how costs should be established and in what circumstances they may be ordered. We also recommend that costs orders made under section 127.1 should be subject to assessment on the application of a respondent.	253
94.	We recommend that consideration be given, on any future review of the Act, to whether it would be appropriate for the Commission to have the discretion to order costs payable to a respondent in Commission proceedings, and, if so, in what circumstances.	253
95.	We support whistle-blower protection in principle, but note that it does not necessarily belong in the Act. Such provisions might more appropriately be included in corporate or employment-related legislation, for example.	254

INTRODUCTION

1. Evolution of the *Securities Act*

The first securities law statute in Ontario *(The Security Frauds Prevention Act 1928)*[5] dealt with little more than the licensing of stockbrokers and investigations into securities frauds. In 1945, securities regulation in Ontario was significantly expanded with the enactment of *The Securities Act, 1945*,[6] which introduced the concept of distributions of securities to the public and required issuers to make certain limited disclosure. *The Securities Act, 1947*[7] imposed additional disclosure and other requirements for public distributions of securities and introduced statutory civil liability for false statements made in a prospectus.

Our current Act originated with *The Securities Act, 1966*,[8] which introduced or modified provisions dealing with continuous disclosure, proxy solicitation, take-over bids and insider trading. These amendments were based largely on the recommendations of the *Report of the Attorney General's Committee on Securities Legislation in Ontario* (informally known as the "Kimber Report"). The closed system was introduced in *The Securities Act, 1978*[9] and in 1983 the take-over bid provisions of the Act were significantly revised as a result of the recommendations of the report of the "Three Wise Men."[10]

The most recent significant amendments to the Act were made in 1994, following the release of a report of a joint Ministry of Finance and Ontario Securities Commission Task Force on Securities Regulation, chaired by University of Toronto law professor Ron Daniels.[11] The Daniels Committee was established in October 1993, following an Ontario court decision[12] declaring a Commission policy statement on the sale of penny stocks invalid on the basis that the Commission had "exceeded its jurisdiction under its enabling legislation in promulgating it." As part of the 1994 Amendments, the Commission was given the authority to make rules with binding legislative effect, subject to a process involving both public comment and review of the proposed rule by the Minister of Finance.

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[5] S.O. 1928, c. 34.

[6] S.O. 1945, c. 22.

[7] S.O. 1947, c. 98.

[8] S.O. 1966, c. 142.

[9] S.O. 1978, c. 47. The closed system was drawn from recommendations of the *Report of the Committee of the Ontario Securities Commission on the Problems of Disclosure Raised for Investors by Business Combinations and Private Placements* (Toronto: Department of Financial and Commercial Affairs, 1970) [hereinafter the "Merger Report"].

[10] Gordon Coleman, Garfield Emerson and David Jackson, *Report of the Committee to Review Provisions of the Securities Act (Ontario) Relating to Take-over Bids and Issuer Bids* (Toronto: Ontario Securities Commission, 1983).

[11] See Task Force on Securities Regulation, *Responsibility and Responsiveness – Final Report of the Ontario Task Force on Securities Regulation* (1994), 17 OSCB 3208 [hereinafter the "Daniels Report"].

[12] *Ainsley Financial Corporation* v. *Ontario Securities Commission* (1993), 14 O.R. (3d) 280 (General Division).

As a consequence of the enactment of the 1994 Amendments, the Commission undertook to review all of its existing policy statements, notices, blanket orders and rulings, and to reformulate them as rules, policies or staff notices or decide they were no longer appropriate or necessary. This process is commonly referred to as the "Reformulation Project."

2. Establishment of the Committee

The 1994 Amendments imposed a requirement that the Minister of Finance (the "Minister") establish an advisory committee every five years to review the legislation, regulations and rules relating to matters dealt with by the Commission and the legislative needs of the Commission.[13] This is the first such committee to be established.

The Act requires the Committee to:

- review the legislation, regulations and rules relating to matters dealt with by the Commission and the legislative needs of the Commission;
- solicit the views of the public in respect of these matters by means of a notice and comment process; and
- prepare for the Minister a report of its review and recommendations.

In addition to this legislated aspect of our mandate, the Minister directed us to ensure that:

- securities legislation in Ontario is up to date; and
- securities legislation in Ontario enables the Commission to proactively enforce clear standards to protect investors and foster a fair and efficient marketplace.

3. The Draft Report

A) REQUEST FOR COMMENTS ON ISSUES LIST

Because our mandate was very broad, our first challenge was to adopt a methodology to guide us. We began by developing an Issues List as a means of soliciting the views of the public. This was prepared with the benefit of input from the Commission. The Issues List was published in the Bulletin on April 28, 2000 and is attached as Appendix C.[14]

The Issues List addressed 42 issues under five broad headings:

i) Principles Underlying Securities Regulation;

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[13] The Act, section 143.12.

[14] See (2000), 23 OSCB 3034 or http://www.osc.gov.on.ca/en/Summary/fiveyearreview.html.

ii) Focus and Scope of Legislation;
iii) Impact of Regulatory Harmonization and Globalization Trends;
iv) Impact of Technology; and
v) Mandate and Role of the Commission.

The Issues List was not intended to be exhaustive or to limit in any way the issues which the Committee was prepared to consider. It was intended to focus the Committee on those areas in which the need for legislative change was viewed as being most pressing and to act as a catalyst for public comment. The Draft Report did not address all of the issues on this list. In many cases, no information or concerns came to the attention of the Committee to cause us to believe that any amendment to the Act was necessary. On the other hand, the Draft Report did deal with a number of issues that were not included on our Issues List, but instead were raised with the Committee by commenters. The Draft Report also addressed issues that were included on the Issues List even though we did not recommend any legislative change in these areas. We did this where we believed the issue was significant enough to merit drawing attention to our analysis and conclusions so that others, who might agree or disagree with us, would have an opportunity to do so.

B) RESEARCH

The Committee's staff prepared memoranda analyzing each of the 42 issues on the Issues List. Additional research was done in response to issues raised by commenters and by the Committee in the course of its deliberations. Much of the work done by the staff was original research. The staff also drew on existing research and analysis by Commission staff and by the staff of other commissions for the CSA. In addition, Commission staff made presentations to the Committee on various issues under consideration by the Committee.

C) COMPARATIVE ANALYSES

The research conducted for the Committee went beyond an analysis of Ontario securities laws. The Committee considered the approach used by securities regulators in other Canadian jurisdictions. We also looked for guidance to the regulatory regimes in the U.S., the U.K. and Australia. Each of these jurisdictions has introduced reforms to various aspects of capital markets regulation in recent years and accordingly the Committee had the benefit of some very thoughtful analysis of securities regulators from across Canada and around the world.

D) WRITTEN SUBMISSIONS AND PRESENTATIONS

The Committee received 31 written submissions in response to our request for comment on the Issues List.[15] Certain organizations and individuals met with us at our request.[16] In addition, Commission staff made presentations on topics of particular interest to the Committee.[17]

E) MEETINGS OF THE COMMITTEE

The Committee met approximately 50 times over a 20-month period prior to the release of the Draft Report.

F) RELEASE OF THE DRAFT REPORT

Our Draft Report was released for public comment on May 29, 2002. The comment period expired on August 15, 2002.

4. The Final Report

A) COMMENTS ON THE DRAFT REPORT

We received written comments from 45 commenters on our Draft Report.[18] We met 24 times between September 2002 and January 2003 to review all the comments we received and to reconsider our initial draft recommendations before finalizing the Report.

B) SUBMISSION OF THE REPORT TO THE MINISTER

The Committee now submits the Final Report to the Minister. The Act requires that the report be tabled with the Legislature and that a select or standing committee of the Legislative Assembly then be appointed to:

- review the report;
- hear the opinions of interested persons or companies; and
- make recommendations to the Legislative Assembly regarding amendments to the Act.

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[15] A list of those individuals or groups who made written submissions to the Committee on the Issues List is attached as Appendix D to this Report. The submissions can be found online at http://www.osc.gov.on.ca/en/Summary/commentletters.html.

[16] A list of individuals and organizations that met with the Committee at the Committee's request regarding the Issues List is attached as Appendix E.

[17] A list of Commission staff who made submissions to the Committee regarding the Issues List is attached as Appendix F.

[18] A list of those individuals or groups who made written submissions to the Committee concerning the Draft Report is attached as Appendix B to this Report. The submissions can be found online at http://www.osc.gov.on.ca/en/Summary/srac_5yr-draft-report-comments.htm. We also met with representatives of the IDA and the BCSC and, at our request, members of the Capital Markets Branch of the Commission.

C) FUTURE COMMITTEES

The Minister will appoint the next Five Year Review Committee at the end of 2004. We anticipate that, since our Report constitutes such a broad survey of securities legislation, subsequent Five Year Review Committees will be able to focus their mandate more narrowly. We suggest that the Act be amended to require that future committees be appointed five years after the date of delivery of the final report of the previous committee, in contrast to the current provision which requires committees to be appointed every five years.

PART 1

THE ROLE OF THE COMMISSION IN CAPITAL MARKETS REGULATION

The activities of participants in Canada's capital markets may be subject to the jurisdiction of securities regulators in up to 13 jurisdictions in Canada and of securities regulators in other parts of the world. Certain activities may also come within the jurisdiction of federal financial institution regulators. Part I of our report discusses how capital markets regulation in Ontario – and across Canada – should be rationalized to increase efficiency without sacrificing investor protection.

THE NEED FOR A SINGLE REGULATOR

We add our voice to countless others raised in support of the urgent need for a single Canadian securities regulator. This is the most pressing securities regulation issue in Ontario and across Canada. We urge the Minister to assume a leadership role in working with her colleagues across the country to resolve any remaining barriers to the establishment of a single regulator responsible for Canada's capital markets activity. To this end, we view the recent establishment of the Wise Persons' Committee recommended by Harold MacKay to the Federal Finance Minister as an excellent forum to move this important initiative forward.[19]

1.1 Capital Market Formation Transcends Borders

A) ONTARIO'S PLACE IN THE CANADIAN CAPITAL MARKETS

Transactions between an issuer and investor who are both resident in Ontario are subject to Ontario securities regulation. However, issuers often do not confine their search for prospective investors to those resident within the issuer's own province or territory and must therefore comply with securities regulatory regimes in more than one jurisdiction. This necessarily increases costs. An issuer must retain the services of registrants and counsel, and pay fees in each jurisdiction in which it proposes to issue securities. It must then hire employees or outside advisers to ensure that it complies with its continuous disclosure obligations in each jurisdiction. From a regulatory perspective, each jurisdiction must maintain the resources necessary to administer and enforce its securities law.[20]

Issuers and investors alike are affected when the costs of compliance in Canada are higher than they are elsewhere. Increased compliance costs affect our competitive position as a source of capital. This, in turn, affects investment opportunities available to Canadians. Issuers who are in a position to do so may look outside of Canada for lower cost of capital. Those who are not in a position to look elsewhere must accept a higher cost of capital and the implications this has for their performance and ability to compete. In order for Ontario capital markets to remain competitive, they must operate as an integral part of the broader Canadian capital markets.

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[19] Letter to The Honourable John Manley, P.C., M.P. from Harold MacKay, dated November 15, 2002 (www.fin.gc.ca). On March 4, 2003, the Wise Persons' Committee was appointed and will be chaired by Michael Phelps.

[20] The FSA estimates that the total cost of Canadian regulation, including prudential regulation and market regulation of securities, insurance, listing and clearing to be about 218 million pounds ($493 million, at current exchange rates) versus the FSA's own regulatory cost of about 220 million pounds ($497 million) and in Australia at 104 million pounds ($235 million). Approximately 3,780 people are employed in Canada to regulate the financial services sector versus 2,765 in the U.K. and 2,113 in Australia. See FSA Annual Report 2000/01 Appendix 5: Comparison of Costs of Regulation in Different Jurisdictions (http:www.fsa.gov.uk/pubs/annual).

Canada's stock exchanges have already reacted to the inefficiencies inherent in regionalization. In order to remain competitive, they have consolidated and restructured,[21] with the result that each of the three remaining exchanges – the TSX, TSX Venture Exchange and the Bourse de Montréal – now deals exclusively with one segment of the market. Senior issuers list on the TSX, junior issuers list on TSX Venture Exchange and derivatives trade on the Bourse de Montréal.[22]

B) CANADA'S PLACE IN GLOBAL CAPITAL MARKETS

Canada represents only two per cent of the world's capital markets.[23] There is literally a whole world of opportunity for both issuers and investors outside our borders. In Chapter 2, we discuss the merits of harmonizing Canadian securities laws with those of other major markets (primarily the U.S.) so that Canadian issuers are not faced with the costs of complying with radically different regimes at home and abroad. Here we note that the challenges of harmonizing our securities laws with those of major world markets are multiplied many times over by our current regime. Canada is the only G-7 industrial country that does not regulate its capital markets through a single regulator. Ensuring that Canadian capital markets remain globally competitive is among the most compelling reasons for consolidating Canadian securities regulation under a single regulator.

1.2 Thirteen Regulators for One Small Market

A) OUR STRUCTURE TODAY

Because securities regulation in Canada is a matter of provincial jurisdiction, there are 13 different sets of securities laws administered by 13 provincial and territorial regulatory authorities. Many of the statutes are similar to one another. Some have provisions that are entirely distinctive. None of them is identical. Even where the statutory provisions are identical, they may be interpreted and applied differently from one jurisdiction to the next.

There is also great variance in the status and function of securities regulators across the country. Some are self-funding agencies. Others are Crown corporations. Still others are agencies of their provincial governments. Some formulate policy, make rules, sit as administrative tribunals and hear appeals from decisions of their executive director or staff. Some perform only certain of these functions. Even where securities regulators perform like functions (such as rulemaking), they typically operate within statutory frameworks that are sufficiently distinctive to make co-ordination of efforts across jurisdictions a major challenge.[24]

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[21] Prior to this restructuring, the Vancouver Stock Exchange, Alberta Stock Exchange, Winnipeg Stock Exchange, TSX, Montreal Exchange and CDN operated independently of one another and, to a large extent, competed with one another for listings.

[22] In August 2001, the TSX acquired the TSX Venture Exchange.

[23] This figure is often used and, while it may have various meanings, in this context we refer to the weight given to Canadian equities in the MSCI World Index. The MSCI World Index is based on the market value of 86 selected equities based on MSCI criteria.

The advantage of the current multiplicity of regimes is that it allows each legislature and securities regulator to develop and administer securities laws in a manner that best serves its local market. Economic activity differs from region to region across the country and securities laws controlled at the provincial level are best able to respond to specific regional needs. However, the price for this local flexibility is a balkanized approach to securities regulation that makes it more time-consuming and expensive for issuers to raise capital across the country. Investors, market participants and their advisers are consistent in their criticism of this approach. In its submission to the Committee, TSX Venture Exchange articulated the frustration expressed by many others with the existence of 13 securities regulatory regimes:

> The complexity in the current regulatory regime is considerably exacerbated by the differences in regulation between provinces. Slight variations in the regulation between provinces may at first seem to be relatively insignificant but these slight differences act as a trap for issuers, their insiders and advisers. In order for an issuer or its insiders to avoid these pitfalls, they must incur additional legal and advisory costs.
>
> We strongly encourage the Government of Ontario, and each of the other provincial governments to provide a strong incentive to their respective provincial securities commissions to work together to create a standardized set of securities rules which can be adopted in each province. Although there may occasionally be the need for certain local initiatives, we submit that such differences should be the exception. ...We note that local differences have often been justified on the basis of accommodating small business; however, we believe that challenges in this area are not regional and a more consistent approach nationally will improve the access to capital.[25]

B) FAILED ATTEMPTS TO CONSOLIDATE

Over the last four decades, there have been several unsuccessful attempts to create a single securities regulatory authority in Canada. In 1964, the Royal Commission on Banking and Finance (known as the Porter Committee) recommended that the federal government establish a single federal agency which would take over the major responsibility for securities regulation from the provinces. The Porter Committee's recommendations were met with mixed reactions. Many felt that, while greater uniformity was desirable, interprovincial co-operation (an alternative considered by the Porter Commission in less detail) was preferable to the establishment of a federal regulatory body.

In 1979, the federal government published *Proposals for a Securities Market Law for Canada*, which also proposed a single securities commission for Canada to regulate international and interprovincial issues of and trading in securities.

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[24] See discussion on Rulemaking in Chapter 7.

[25] See comment letter on the Issues List of TSX Venture Exchange.

In 1994, the federal government released a draft memorandum of understanding[26] proposing an autonomous Canadian Securities Commission to which both the federal and provincial governments would delegate regulatory power. While this effort came closer than previous initiatives to achieving its goal, jurisdictional and political obstacles resulted in the effort being abandoned.[27]

C) FEDERAL AND PROVINCIAL INITIATIVE

In October 2002, Harold MacKay was commissioned by the Federal Minister of Finance to recommend an approach to reform Canada's securities regulatory framework. Mr. MacKay delivered his report to the Honourable John Manley in November. The report identified several concerns with the current regulatory structure similar to concerns raised in previous reports, including ours. The report states that the "[c]urrent system, as presently operated, is inadequate to meet the challenges of today and tomorrow. While not broken, it must be improved significantly, and in a prompt manner."[28] To this end, Mr. MacKay recommended that a Wise Persons' Committee be established by the federal government and interested provinces to review the current regulatory system with a mandate to recommend an appropriate model for securities regulation in Canada. The federal government recently endorsed this recommendation and appointed a committee. The Wise Persons' Committee will:

- review and assess the strengths and weaknesses of the existing system of securities regulation in Canada;
- recommend a regulatory structure for Canada that is achievable and that will best meet Canada's needs;
- recommend a governance model and describe an accountability framework; and
- submit its report by November 30, 2003.[29]

D) INTERPROVINCIAL HARMONIZATION THROUGH THE CSA

The CSA is an informal body comprised of the 13 provincial and territorial securities regulators. It functions through regular meetings of the chairs, vice-chairs and staff of each of the commissions, through ad-hoc interactions between executive directors and staff of each of the commissions, and through staff committees established to deal with joint regulatory initiatives and issues of shared concern. Funding and support resources are drawn from the operating budgets of each of the commissions on a voluntary basis.

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[26] *Memorandum of Understanding Regarding the Regulation of Securities in Canada* (1994), 17 OSCB 4394.

[27] See also the discussion of the history of prior attempts to reform securities regulation in Canada found in A. Douglas Harris, *A Symposium on Canadian Securities Regulation: Harmonization or Nationalization?* "White Paper" (University of Toronto Capital Markets Institute, October 2002) pp. 5-69.

[28] *Supra* note 19.

[29] These are applications for relief that are evidenced by the issue of a receipt for a prospectus.

The CSA has made significant contributions to the harmonization of securities laws and the administration of those laws across Canada. Its accomplishments include the establishment or proposed launch of:

- "MRRS" – mutual reliance review systems (discussed below) which cover, for example, applications for discretionary relief and the review of prospectuses, annual information forms and rights offering documents;
- "SEDAR" – the System for Electronic Document Analysis and Retrieval, which makes documents filed by reporting issuers available to anyone with access to the Internet.
- "SEDI" – the System for Electronic Disclosure by Insiders, a central electronic system for insider reporting; and
- "NRD" – the National Registration Database, a web-based system that will permit dealers and advisers to file registration forms electronically.

Through the CSA, Canada's 13 regulators have also achieved legislative uniformity in many areas by adopting national and multilateral instruments. There are now 25 "National Instruments" – rules and regulations developed through the co-operative efforts of the CSA and subsequently adopted in each of the provinces and territories. National Instruments have harmonized the regulation of prospectus disclosure,[30] mutual fund regulation,[31] matters relating to early warning requirements and take-over bids,[32] registration issues[33] and marketplace operation and trading rules.[34]

Notwithstanding the achievements of Canadian regulators, the limitations of the CSA as a vehicle to co-ordinate Canadian securities regulations are apparent. We note five in particular:

1. Although the CSA seeks to balance national harmonization with regional flexibility, regulators in each jurisdiction are free to insist on their own approach rather than working with their counterparts in other jurisdictions to craft a common solution. This was evidenced by the revisions made to the exempt distribution rules in Ontario in 2001 and in British Columbia and Alberta shortly thereafter.[35] As a result of this process, Ontario,

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[30] E.g., National Instrument 41-101 *Prospectus Disclosure Requirements* (2000), 23 OSCB (Supp.) 619.

[31] E.g., National Instrument 81-101 *Mutual Fund Prospectus Disclosure* (2000), 23 OSCB (Supp.) 3, National Instrument 81-102 *Mutual Funds* (2000), 23 OSCB (Supp.) 59 and National Instrument 81-105 *Mutual Fund Sales Practices* (1998), 21 OSCB 2713.

[32] E.g., National Instrument 62-103 *The Early Warning System and Related Take-Over Bid and Insider Reporting Issues* (2000), 23 OSCB 1372, and National Instrument 62-202 *Take-Over Bids – Defensive Tactics* (1997), 20 OSCB 3525.

[33] E.g., National Instrument 35-101 *Conditional Exemption from Registration for United States Broker-Dealers and Agents* (2000), 23 OSCB 8511.

[34] E.g., National Instrument 21-101 *Marketplace Operation* (2001), 24 OSCB 6591 and National Instrument 23-101 *Trading Rules* (2001), 24 OSCB 6635.

[35] See for Ontario, Rule 45-501 *Exempt Distributions* (2001), 24 OSCB 7011 and for Alberta and B.C., Multilateral Instrument 45-103 *Capital Raising Exemptions* (BCN 2002/16).

on the one hand, and British Columbia and Alberta, on the other, will continue to have different exempt distribution rules, similar in some respects, different in others. In our view, this represents not only a missed opportunity for harmonization, but also a regrettable step backwards for a more rational securities regime in Canada.

2. National policies and rules cannot be developed and implemented quickly because 13 different regulatory authorities must agree first on policy directions and then on specific requirements. The initiative must then go through the approval process applicable in each jurisdiction (in Ontario, for example, the comment period and Ministerial approval process for rules, discussed more fully in Chapter 7).

3. The CSA has no powers of enforcement, and accordingly, a co-ordinated approach to enforcement currently must be undertaken on an ad-hoc basis.[36] The consolidation of Canada's capital markets and the integration of our markets with other global markets are accentuating national and international enforcement issues. We believe this is critical to the credibility of the Canadian capital markets.

4. The CSA is accountable to no one. Whether it succeeds or fails will depend on the commitment of each jurisdiction.

5. We are seeing more divergent and competing visions from different CSA members on the objectives and structure of securities regulation.[37] As one observer noted, we "are not only getting different interpretations of rules, we are getting different philosophies."[38] With no co-ordinated focus to all these initiatives, the risk is that rather than pursuing an ideal system, the country's system of securities regulation grows ever more fragmented and cumbersome.

E) MRRS – A STEP IN THE RIGHT DIRECTION

The CSA implemented MRRS in 1999.[39] MRRS is based on a decision-maker in one jurisdiction being prepared to rely primarily on the analysis and review of staff in another jurisdiction. For example, if an issuer wishes to issue securities in more than one jurisdiction in Canada, MRRS allows the issuer to deal with one principal regulator (usually the regulator in the jurisdiction where the company's head office is located) rather than the regulators in each of the relevant jurisdictions. Staff of the principal jurisdiction provide comments to the issuer on behalf of all of the Commissions and make recommendations. The issuer then receives a single decision document from the regulator in the principal jurisdiction.

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[36] The discussion of MRRS below makes reference to the CSA's expressed intention to engage in some degree of voluntary co-operation in this area.

[37] For example, the Commission generally supports the idea of a national regulator, the Alberta Securities Commission is leading the CSA's Uniform Securities Law project, and the BCSC is advocating streamlining and simplification before more harmonization (see the BCSC's "New Proposals for Securities Regulation," June 2002). More recently, CSA members appear to be at odds over the appropriate Canadian response to the U.S. *Sarbanes-Oxley Act of 2002*.

[38] Tom Hockin, "It's time to get practical about a national securities commission," *National Post* (October 3, 2002).

[39] *Memorandum of Understanding - Mutual Reliance Review System* (1999), 22 OSCB 6813.

MRRS is a formalized approach to voluntary co-operation among securities regulatory authorities. None of the regulators surrenders any jurisdiction or discretion. Each jurisdiction retains its statutory discretion with respect to all matters being considered under mutual reliance and can "opt out" at any time and deal with the market participant directly. No changes have been made to securities laws as a result of MRRS. In fact, harmonization is not an objective of MRRS. The CSA has stated only that harmonization is "an indirect benefit that may be achieved over time" as a result of MRRS.

MRRS deals with, or is expected in the future to be extended to, the following areas:

- exemptive relief applications;
- prospectuses (including long form, short form and mutual fund prospectuses and amendments, and rights offering circulars);
- waiver applications;[40]
- pre-filing discussions;
- initial and renewal annual information forms;
- applications for registration, reinstatement of registration and renewal of registration;
- continuous disclosure documents;
- investigations and hearings; and
- rulemaking and policy-making initiatives.

MRRS is a significant step forward in achieving interprovincial co-ordination. It has streamlined the regulatory process when more than one jurisdiction is involved. However, we share the reservations expressed in a number of submissions about the limitations of MRRS. For example, the Canadian Association of Insurance and Financial Advisers wrote:

> While we have come to appreciate the ability of a lead regulator to co-ordinate a series of interprovincial applications, we believe that the potential for mutual reliance remains to be realized. For example, there can be little justification for the continuing need to file individual paper applications to each regulator and to pay fees for amounts that vary from $0 to $750 to each regulator when the lead or co-ordinating regulator charges $450 and does most of the work.

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[40] These are applications for relief that are evidenced by the issue of a receipt for a prospectus.

We note the following limitations of MRRS:

- MRRS does not ensure uniformity in the administration of securities laws across Canada. Each jurisdiction retains the right to interpret and apply national instruments in its own way and to apply its own local requirements to whatever issues come before it. In addition, a regulator can "opt out" of MRRS when it disagrees with the decision reached by the principal regulator. The possibility that one or more regulators could opt out means that MRRS has created neither a predictable nor a uniform approach to securities regulation.
- MRRS has not reduced costs to the industry. Staff in the non-principal jurisdictions may undertake an independent review on multi-jurisdictional filings. Market participants must still pay the same fees in each jurisdiction as were payable prior to the adoption of mutual reliance.
- Securities laws are not uniform across all jurisdictions. Differences exist, for example, with respect to prospectus offerings, exemptions from the prospectus and registration requirements, take-over bids, continuous disclosure and enforcement powers. MRRS does not alleviate the need for market participants to be familiar with, seek advice on, and comply with the different requirements that exist across the country. There is considerable cost associated with this exercise.

1.3 The Final Push for a National Securities Regulator

A) WHAT IS THE APPROPRIATE MODEL?

In order for Canadians to have world-class opportunities both to raise capital and to invest their savings, a dramatic change in the structure of our regulatory regime is required. The ongoing consolidation and internationalization of markets around the world demands that we be less focused on provincial and territorial concerns and more focused on national and international harmonization. We believe that the solution is the establishment of a single securities regulator with responsibility for the capital markets across Canada, but with regional offices so that territorial concerns are taken into consideration. There is an urgent need to assign the highest priority to this issue on the policy agenda of our respective governments and regulators.

Most of the submissions made to the Committee support the creation of a single Canadian securities regulator.[41] For example, the Ontario Teachers' Pension Plan, one of Canada's largest institutional investors, endorses a single regulator as a means of establishing and enforcing appropriate regulatory standards across the country:

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[41] See comment letters of Simon Romano, BMO Nesbitt Burns, Canadian Bankers Association, Gowling Lafleur Henderson LLP, Securities Subcommittee of the Ontario Bar Association, the TSX, Certified General Accountants of Ontario, Association for Investment Management and Research, Canadian Association of Insurance & Financial Advisors, Ontario Teachers' Pension Plan, Canadian Investor Relations Institute, PricewaterhouseCoopers LLP, Investment Counsel Association of Canada, Certified General Accountants Association of Canada, Royal Bank of Canada, and the IDA.

> We come at the problem of regulatory harmonization in the securities area from a deliberately naïve perspective, and prefer to put political and constitutional issues aside in articulating our position. We recognize that, in fact, coming to the "sensible" conclusion for Canada is not straightforward. A national system of securities regulation is the desirable end result. No matter how good Ontario gets, if the system is based on harmonization and co-operation, and other jurisdictions have less good standards and enforcement capabilities, there will be a "race to the bottom."
>
> Issuers will earn the right to raise money in the capital markets in less rigorous regulatory environments, get listings in the premium markets, and tarnish the reputation of the entire country. The provinces need to recognize that Canada is suffering as a destination for business and capital because they refuse to give up jurisdiction to a first class regulatory regime that is administered and enforced by a first class regulator. Canada needs to get on one page in securities administration if it hopes to compete globally.[42]

Another commenter also supports a single regulator:

> With respect to the efficiency of our regulatory model, we believe that much work needs to be done to reduce the duplicative and costly system of provincial regulation that exists in Canada. While much effort has been expended in making our current system operate more effectively, it is simply not credible to argue that the involvement of multiple regulators that exists within the CSA can achieve the efficiency of a national securities regulator.[43]

We also believe that international co-operation and collaboration would be made much easier for Ontario (and Canada) through a single securities regime. Under our current regulatory regime, it is not entirely clear who, if anyone, speaks for Canada.

The Committee makes no recommendation about how a single Canadian securities regulator should be constituted. Previous proposals for a federal regulator could be revived, with efforts renewed to remove the remaining roadblocks.[44] Alternatively, a supra-provincial body to which the provinces and territories delegate their authority could be established. Other models may also be proposed as this project moves forward.

B) A LESSON FROM AUSTRALIA

During the Committee's deliberations, we examined with interest the recent experience in Australia, where securities regulation was rationalized along national lines. From a starting point prior to 1970 when corporate and securities laws were matters of state and territorial jurisdiction, through a number of failed initiatives designed to harmonize their approach to securities regulation, the states and territories of Australia ultimately agreed to the enactment of federal legislation dealing with corporate and securities law which draws on state and territorial powers as well as federal powers. The result was the creation of the Australian Securities Commission (now the Australian Securities and Investment Commission) as the national regulator, with full responsibility for the regulation of companies. The Australian experience is described in Appendix G.

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[42] See comment letter on the Issues List of the Ontario Teachers' Pension Plan.

[43] See comment letter on the Issues List of Torys LLP.

[44] To date, the provinces have asserted jurisdiction over securities regulation under their power over property and civil rights in the province. However, over the past few decades securities activity has gradually acquired more of an inter-provincial or national character. The Federal Government therefore may have overlapping jurisdiction in securities regulatory matters under its "trade and commerce power" or under its general power to create legislation for the "Peace, Order, and Good Government of Canada."

We found the Australian experience instructive because of the range of alternatives that were explored before a solution was achieved. The constitutional issues in Australia are similar to those we face in Canada, as are issues of interjurisdictional co-operation. The Canadian solution may well be different from the Australian solution. However, we encourage all levels of government in Canada and securities regulators in every jurisdiction to follow the Australian lead.[45] We believe that creativity and compromise will result in a system that allows Canadian issuers and investors to function more effectively in the global marketplace.

C) MOVING FORWARD IN THE MEANTIME

As we move to establish a single Canadian securities regulatory regime, we must also continue to move forward with our harmonization efforts. This will allow Canadian capital markets to benefit from the economies of harmonization on an incremental basis and will smooth the path to a single regulator.

i) Harmonization of Securities Laws

If Canada's 13 provinces and territories could harmonize their securities laws, this would go a long way to simplifying capital markets regulation in Canada. It is clearly an enormous endeavour requiring significant resources, time and political will in order to harmonize legislation in the first instance and then to make amendments to each jurisdiction's legislation in a co-ordinated and harmonized way on an ongoing basis. The CSA has embarked on a uniform securities law project, with "a target of developing a uniform securities act and rules by each jurisdiction of Canada on a fast-tracked basis."[46] We applaud these efforts and encourage the CSA to move this important initiative forward on a priority basis. In addition, we encourage the CSA to use the opportunity which the uniform securities law project presents to also consider updating and simplifying the current regulatory system in Canada.[47] We stress, however, that we do not view the development of uniform securities law in Canada as a substitute for the ultimate goal of creating a single securities regulator. In this regard, we believe that even if the CSA is able to achieve uniformity, it will be difficult, in practice, to maintain. In particular, our current regulatory structure leaves too many opportunities for individual CSA members to apply and interpret uniform law differently and undertake new local initiatives subsequent to the adoption of the uniform law.

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[45] Several judicial decisions had cast doubt on the constitutionality of Australia's framework for corporate regulation. See Ian Ramsay, *The Unravelling of Australia's Federal Corporate Law*, (http://cclsr.law.unimelb.edu.au/Bulletins/Bulletin0031.htm) for a full discussion of the relevant cases. In response to these judicial decisions, legislation was recently introduced in which Australian states referred their constitutional powers with respect to corporate regulation and the regulation of the securities and futures industries to the Australian Commonwealth. See the *Australian Securities and Investment Commission Act, 2001* (No. 51, 2001), section 11.

[46] See CSA's Uniform Securities Legislation Project – *Blueprint for Uniform Securities Law for Canada* (2003), 26 OSCB.

We also encourage the Commission to take the lead in promoting harmonization and co-operation within the CSA. We note that one commenter stressed that the Commission should be particularly sensitive to the issue of harmonization when exercising its rulemaking authority:

> We believe the goals of increased harmonization and co-operation should be given greater weight in the development of rules and policies by the Commission. We recognize that the Commission must retain the ability to act in the public interest even if the result is to further fragment the Canadian securities regulatory regime, but we would suggest that this should be the exceptional case….In the absence of a [single securities] regulator, the Commission should recognize the need for coherent, harmonized Canadian regulation when exercising its rulemaking authority.
>
> We would propose that when exercising its rulemaking authority the Commission should:
>
> (i) adopt rules that have the effect of increasing the degree of harmonization and co-operation;
>
> (ii) make every effort to have the same rule adopted by the other Canadian securities regulatory authorities (to the extent necessary); and
>
> (iii) not adopt any rule that has the effect of lessening the degree of harmonization or co-operation, unless such rule is required in the public interest notwithstanding such effect.[48]

We agree with the commenter that the foregoing principles are important and should be addressed by the Commission in the rulemaking process (see also the discussion in Chapter 7 on rulemaking and cost-benefit analyses). We note, however, that some commenters expressed concern about placing too much emphasis on harmonization. In particular, some believe that harmonization may result in a "race to the bottom" in policy development and a "regulatory time lag" that is not acceptable to address changes in capital markets and to provide useful remedies for the benefit of investors.[49] In this regard, one commenter stated:

> We recommend that the focus of the Final Report not distract from the needs to protect the important and extensive capital markets that operate in Ontario because of an undue emphasis to attempt to "harmonize" Ontario's regulatory regime on a Pan-Canadian provincial basis. Ontario's own securities regulatory initiatives historically have attempted to achieve world class

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[47] For example, the CSA should consider some of the initiatives of the BCSC's Deregulation Project.

[48] See comment letter of Ogilvy Renault.

[49] See comment letters of Fasken Martineau DuMoulin LLP and the Canadian Bankers Association.

> status based on a principle-based investor protection requirements that create confidence in the integrity of the capital markets that operate in Ontario.
>
> First and foremost, Ontario's objectives should continue to be to provide regulatory leadership for the benefit of the securities industry and capital markets in Ontario and for the protection to investors who trade in Ontario. History has shown that Ontario's leadership in setting capital market standards has also had a positive effect in Canada and on other provincial regulatory regimes.[50]

We are very cognizant of the limitations of harmonization as a means for setting policy agendas. As noted previously, however, we view harmonization as a means to an end: the creation of a single securities regulator in Canada.

ii) Delegation and Mutual Recognition

Even if securities laws across the country were harmonized, this would not eliminate the administrative duplication inherent in having 13 regulators administering and enforcing those laws. In our view, the most efficient interim solution to deal with this issue is for each of the jurisdictions to move expeditiously to amend their legislation in two ways. First, securities regulators should be empowered to delegate authority to a securities regulator in another Canadian jurisdiction – moving from our current system of voluntary mutual reliance to a system of true reliance. This would eliminate the need for staff in each jurisdiction to undertake an independent review of a multi-jurisdictional filing and would eliminate the entitlement of individual jurisdictions to opt out. Some have called for a "passport system" to be adopted in Canada whereby regulatory approval by one CSA member would be recognized by all CSA members. The statutory power to delegate is vital if a passport system is to function effectively. It must be recognized, however, that the effectiveness of a delegation model will ultimately depend on the willingness of all CSA jurisdictions to enact similar provisions ceding jurisdiction. On a practical level, it will also be imperative that each CSA jurisdiction exercise regulatory restraint and truly rely upon the body to which it has delegated authority.

Second, securities laws across the country should be amended to provide for "mutual recognition." Mutual recognition is based on the principle that the rules of the jurisdiction having the closest connection to a transaction or market participant (the "home jurisdiction") will govern that transaction or market participant, and other affected jurisdictions (the "host jurisdictions") will recognize and allow those rules to be applied in place of their own. Mutual recognition could be particularly helpful in a delegation environment where the laws of each jurisdiction are not completely uniform. In particular, it would obviate the need for a commission that is exercising authority that has been delegated by another commission from having to apply several different laws to a registration application, a prospectus, or an application for exemptive relief. The concept of mutual recognition forms the basis of the Canadian–U.S. multi-jurisdictional disclosure system (MJDS). It also implicitly underlies other rules which provide exemptive relief from the need to comply with Canadian law provided the laws of certain foreign jurisdictions are complied with instead.[51] If compliance with foreign law is viewed as a satisfactory proxy for compliance with Canadian securities regulatory requirements, we believe that Canadian regulators should be able to put aside historical differences and regional preferences to conclude that where requirements in different provinces are similar (albeit not identical), compliance with the laws of another province will suffice.[52]

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[50] See comment letter of Fasken Martineau DuMoulin LLP.

We recognize that there may be constitutional and other legal issues that will need to be addressed in implementing this proposal. For example, consequential amendments to the Act's immunity provisions may be necessary to extend immunity from liability to other provincial securities regulators and their employees who act as delegatees.[53] We encourage the CSA to work on implementing an effective delegation and mutual recognition model and to provide for delegation and mutual recognition as part of its uniform securities law project.[54] We also urge the provincial governments across Canada to support these important initiatives.

Recommendations:

1. We recommend that the provinces, territories and federal government work towards the creation of a single securities regulator with responsibility for the capital markets across Canada. To this end, we strongly encourage the Government of Ontario to actively support the Wise Persons' Committee recently established by the Federal Finance Minister.

2. In the meantime, we recommend that certain steps be undertaken by securities regulators to simplify the current regulatory regime in Canada: (i) We recommend that securities regualtors continue to harmonize securities regulation across Canada; (ii) We recommend that securities regulators be given the authority to delegate any power, duty, function or responsibility conferred on them to another securities regulatory authority within Canada, and that they actively engage in delegation among themselves. We therefore recommend the Act be amended to give the Commission this delegation authority, and that the necessary consequential amendments to the immunity provisions in the Act be made; (iii) We recommend that securities legislation across the country be amended to provide for "mutual recognition" so that the rules of the jurisdiction having the closest connection to a transaction or market participant will govern that transaction or market participant, and other affected jurisdictions will recognize and allow those rules to be applied in place of their own.

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[51] See proposed National Instrument 71-102 *Continuous Disclosure and Other Exemptions Relating to Foreign Issuers*.

[52] See for example, Alberta Securities Commission Rule 41-501 *Use of Prospectus Complying with Ontario Securities Commission Requirements*, which permits issuers to satisfy certain of the prospectus requirements under Alberta securities law by complying with OSC Rule 41-501 *General Prospectus Requirements*.

[53] The Act, subsection 141(1).

[54] We note that the CSA's Uniform Securities Legislation Project – *Blueprint for Uniform Securities Laws for Canada* includes a proposal that securities regulatory authorities should be allowed to delegate all regulatory functions among themselves, subject to certain restrictions.

THINKING GLOBALLY IN SECURITIES REGULATION

"Globalization" is more than just a catchphrase in the context of capital markets. Increasingly, issuers are able to raise capital in whatever market around the globe offers them the best arrangements while investors are able to trade on a variety of exchanges around the world.

This chapter describes the impact of globalization on the Canadian capital markets and proposes two areas in which Canada should take the steps necessary to be a global participant. It also endorses the Commission's participation in IOSCO.

2.1 Global Harmonization

The globalization of capital markets is evidenced by a number of trends, including:

- the growth of cross-border securities transactions;
- an increasing number of additional listings of Canadian companies on foreign exchanges;
- the emergence of multinational securities firms servicing businesses from offices around the world; and
- an increasing number of strategic alliances and other connections between regulated financial markets in different parts of the world.[55]

Canadian issuers have looked to the U.S. market in particular, whether to obtain a listing on NASDAQ or the NYSE, access the investment grade or high yield debt market or simply to broaden their financing prospects. Many Canadian issuers have listings on U.S. stock exchanges.[56] The introduction of MJDS in 1991 facilitated access to the U.S. capital markets by Canadian reporting issuers and vice versa.

2.2 Financial Reporting for Global Accessibility

A) CURRENT GAAP REQUIREMENTS

Ontario securities and corporate laws currently require Canadian reporting issuers to prepare their financial statements in accordance with Canadian GAAP. Foreign reporting issuers may use the accounting principles of their home country, but must provide a reconciliation to Canadian GAAP for financial statements in a prospectus.[57]

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[55] Allan Cameron, *The Globalization of the Securities Market* (Seminar on the Globalization of Securities) (Allen Allen & Hemsely, August 16, 1999).

[56] As of December 31, 2002, 212 TSX-listed companies were interlisted on a U.S. market. For 2002, U.S. markets represented 52.4 per cent of the volume and 45 per cent of the value of stocks interlisted with the TSX.

Canadian issuers who access the U.S. capital markets often consider it desirable to provide financial information to the U.S. marketplace that conforms to U.S. GAAP. This enhances the ability of American investors and analysts to understand the issuer's financial performance and to compare it to the performance of other issuers who report in U.S. GAAP. However, this requires the Canadian issuer to prepare two complete sets of financial statements, one in Canadian GAAP to satisfy Canadian legal requirements and one in U.S. GAAP. Foreign issuers who access the Canadian capital markets have the same problem in reverse, although they more often elect to simply provide a reconciliation to Canadian GAAP. Preparing two sets of financial statements or a reconciliation is both time-consuming and expensive for the issuer.

B) CSA DISCUSSION PAPER

In March 2001, the CSA issued Discussion Paper 52-401 *Financial Reporting in Canada's Capital Markets* (the "Financial Reporting Discussion Paper") for comment.[58] It notes that "the growth of cross-border financing activity has focussed attention on impediments to companies wishing to offer their securities or have them listed in another jurisdiction." It identifies differences in accounting standards as one such impediment. The CSA sought comment on possible changes to existing requirements dealing with accounting standards used for financial statements filed by issuers. In particular, the CSA was considering whether Canadian and foreign reporting issuers should be permitted to use U.S. GAAP or the international accounting standards (IAS) developed by the International Accounting Standards Committee (IASC), which were recently endorsed by IOSCO, with limited or no reconciliation to Canadian GAAP.[59]

The Financial Reporting Discussion Paper identified several issues that would need to be considered in deciding whether to accept IAS or U.S. GAAP for regulatory filings in Canada:

- Comparability – Having as many as three sets of accounting standards for reporting issuers would make it difficult for Canadian investors and analysts to compare results for different companies. The CSA acknowledged, however, that the peer group for some Canadian companies comprises foreign companies that do not prepare Canadian GAAP statements.

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[57] Foreign reporting issuers are not required to provide a reconciliation for continuous disclosure filings under Ontario securities law. We understand, however, that such a requirement is often imposed as a condition of obtaining a continuous disclosure exemption frequently provided to foreign companies.

[58] (2001), 24 OSCB 1678.

[59] Since the early 1990s, IOSCO has been working with the IASC to develop a set of standards that could be accepted by all regulators for cross-border offerings. In May 2000, IOSCO completed its assessment of the suitability of 30 accounting standards developed by the IASC. IOSCO approved a resolution recommending that its members permit the use of the IASC standards, supplemented by reconciliation, disclosure and interpretation as necessary to address outstanding substantive issues at a national or regional level. The Canadian Accounting Standards Board (the "AcSB") has been working with major foreign standards-setting bodies toward the convergence of accounting standards. The goal of convergence is to develop IAS as a single set of internationally accepted accounting standards. The AcSB has also been working to eliminate the major differences between Canadian and U.S. accounting standards.

- Professional Capacity – Canadian accounting professionals have limited knowledge of U.S. GAAP and virtually no experience with IAS. A significant effort would be required for companies, auditors and regulators to build expertise to support a rigorous interpretation and application of such standards.
- Other Statutory Requirements – Even if the CSA were to permit Canadian companies to prepare their financial statements in accordance with U.S. GAAP, companies may still be required under corporate or tax statutes to file Canadian GAAP financial statements. The potential benefits flowing from a CSA exemption would only be fully realized if these other requirements could also be changed.

C) PROPOSED NATIONAL INSTRUMENT 51-102 CONTINUOUS DISCLOSURE OBLIGATIONS

In June 2002, the CSA published for comment proposed National Instrument 51-102 *Continuous Disclosure Obligations.*[60] The National Instrument seeks to harmonize continuous disclosure requirements across Canada and will apply to all issuers, other than investment funds, that are reporting issuers in one or more Canadian jurisdictions. The National Instrument proposes to permit SEC Issuers[61] to file with the CSA financial statements prepared in accordance with U.S. GAAP, subject to a two-year reconciliation period.

D) PROPOSED NATIONAL INSTRUMENT 71-102 CONTINUOUS DISCLOSURE AND OTHER EXEMPTIONS RELATING TO FOREIGN ISSUERS

In June 2002, the CSA published for comment proposed National Instrument 71-102 *Continuous Disclosure and Other Exemptions Relating to Foreign Issuers.* The proposed national instrument permits eligible foreign issuers to file financial statements prepared in accordance with IAS, without reconciliation to Canadian GAAP.[62]

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[60] (2002), 25 OSCB 3701.

[61] Under NI 51-102, an "SEC Issuer" is an issuer that has a class of securities that is registered under section 12 of the 1934 Act or that is required to file reports under section 15(d) of the 1934 Act, and that is not registered as an investment company under the U.S. Investment Company Act of 1940. Issuers incorporated in Canada and having a majority of shareholders, assets and operations in Canada may qualify as SEC Issuers. Also, SEC Issuers will be permitted to file audit reports in accordance with U.S. generally accepted auditing standards.

[62] An "eligible foreign issuer" is a reporting issuer, other than an investment fund, that is incorporated outside of Canada, unless it has more than 50 per cent of its shares held in Canada and one or more of the following is also true: the majority of its directors and officers are Canadian residents; more than 50 per cent of its assets are in Canada; or the business is principally administered in Canada. (2002), 25 OSCB 3823.

E) THE TIME HAS COME TO MOVE AWAY FROM CANADIAN GAAP

We share the concerns expressed in the Financial Reporting Discussion Paper that the current multitude of accounting standards involved in cross-border offerings and listings can make it very difficult to compare financial information from issuers based in different countries. In this regard, NI 71-102 specifically contemplates permitting eligible foreign issuers reporting in Canada to use financial statements prepared in accordance with IAS without reconciliation to Canadian GAAP. We strongly encourage the move by Canadian regulators and standard setters to IAS and hope that Canada will continue to play a role in this area – with the ultimate goal of permitting both domestic and foreign issuers to report under IAS without a reconciliation to Canadian GAAP.

We note that some commenters on our Draft Report believe that much work remains to be done before Canada should fully embrace IAS.[63] For example, there is no effective structure in place yet for the enforcement of IAS. Also, IAS are not fully developed in terms of detailed interpretation and practice. We agree that these are legitimate concerns that will need to be considered by Canadian regulators prior to acceptance of IAS. We believe that Canadian and foreign standard setters have evidenced a renewed commitment to achieving the convergence of national standards into a universal set of standards under the leadership of the International Accounting Standards Board (IASB). We view the recent announcement by the U.S. Financial Accounting Standards Board and IASB to bring about convergence between their different standards by 2005 as an extremely positive step toward achieving global accounting harmonization and thus potentially accelerating the time horizon for acceptance of IAS in Canada.[64]

While we strongly support the development of robust IAS, we also believe that a more immediate issue for Canada at this time is whether reporting issuers (both Canadian and foreign) should be permitted to prepare their statements in accordance with U.S. GAAP without reconciliation to Canadian GAAP. In this regard, we do not think that we can afford to ignore the vast amount of cross-border activity that exists between Canada and the U.S. When an issuer competes with other issuers who prepare their statements in accordance with U.S. GAAP, investors (and issuers) may be at a disadvantage if financial statements are reported in accordance with Canadian GAAP only.

There are differences between U.S. and Canadian GAAP. For example, Canadian accounting standards are, generally speaking, less prescriptive and rule oriented than U.S. standards, thereby providing more scope for the application of professional judgement. There are also substantive differences in specific areas, such as accounting for foreign currency transactions and inventory accounting. In some cases, these differences can have very significant effects on the way in which the results of operations are reported. Nevertheless, Canadian standard setters have been working over the years to reduce the number of differences between Canadian and U.S. GAAP.[65] Consequently, we question whether the remaining differences between Canadian and U.S. GAAP are so significant that they should preclude the use of U.S. GAAP by Canadian and foreign companies. Moreover, given the familiarity of the Canadian investment community with U.S. GAAP, we are not convinced that investor protection concerns justify the requirement for financial statements to be prepared in accordance with Canadian GAAP in these situations.

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[63] See comment letters of PricewaterhouseCoopers LLP and TSX Venture Exchange.

[64] Joint FASB/IASB press release dated October 29, 2002, "*FASB and IASB Agree to Work Together Toward Convergence on Global Accounting Standards*" (www.iasc.org.uk). Also, the European Commission has issued a draft regulation that will require the use of IAS by 2005 for all EU companies listed on a regulated market: see "*Financial reporting: Commission proposes requirement for listed companies to use International Accounting Standards by 2005*" (http://europa.eu.int/comm/internal market/en/company/account/news/ias.htm).

We received a number of submissions supporting the use of U.S. GAAP in financial statements that are required to be filed with the Commission.[66] The IDA noted that "[i]ndividual investors would not be disadvantaged if Canadian corporations reported in U.S. GAAP." Another commenter stated:

> My vision is that any company could raise capital in Canada and satisfy its reporting obligations by preparing its documents in accordance with Canadian GAAP, U.S. GAAP, or International GAAP, without reconciliation to a Canadian benchmark. I believe that U.S. GAAP must be permitted, in spite of a world wide desire for common global standards, until such time as the U.S. embraces International standards as acceptable for primary financial statements within U.S. borders. Although not without its faults, U.S. GAAP is arguably the most comprehensive and sophisticated set of accounting principles in the world. ...
>
> The driving factor behind acceptance of a set of standards should not be local views as to what is the "right" accounting, but recognition that the standards have been developed by a competent body with sufficient resources, processes and input from all interested parties that the product can be considered high quality. I think that can now be said of both International and U.S. accounting standard setting.
>
> ...Although, as I noted earlier, there are differences even in a "harmonized" world, I don't believe that the nuances in the differences are sufficient to require a reconciliation to aid a user's understanding of the financial statements. (I like Molson's Joe, and like him, I am Canadian, but I don't think that we need to be so "Canadian" that we won't let people read and interpret International and U.S. GAAP financial statements without a Canadian GAAP interpretation beside it.) There is nothing so unique about Canadian standards that a Canadian user is placed at undue risk by relying on financial statements prepared in accordance with...U.S. standards (recognizing that a user should be reasonably well-informed to start, and actually read and interpret the

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[65] For example, there has been harmonization, or work in progress to achieve harmonization, between U.S. and Canadian GAAP in the following areas: cash flow statements, methods of recording income taxes, segment information, accounting for R&D arrangements, and accounting and reporting of stock based compensation.

[66] See comment letters on the Issues List of KPMG, Michael Tambosso of PricewaterhouseCoopers, the IDA, and Simon Romano of Stikeman Elliot and comment letters on the Draft Report of the Association for Investment Management and Research, Ontario Teachers' Pension Plan, the Investment Counsel Association of Canada, the TSX, the Canadian Bankers Association, PricewaterhouseCoopers LLP, Certified General Accountants of Ontario, Royal Bank of Canada, and the Securities Subcommittee of the Ontario Bar Association.

> financial statements and notes). Moreover, as noted, it is critical that we turn to the processes by which the standards are developed, and not personal or local views on specific outputs.[67]

The Committee received no compelling submissions opposing the proposal to allow both foreign and Canadian companies to prepare their financial statements in accordance with U.S. GAAP.[68]

We recognize that the acceptance of U.S. GAAP raises some challenging transitional issues, such as the degree of professional capacity which exists in Canada to deal with U.S. standards. However, the benefits that will accrue to issuers and investors eclipse the challenges that these issues present. At the same time, however, it will be appropriate to require that Canadian issuers that choose to prepare only U.S. GAAP financial statements provide a reconciliation to Canadian GAAP for a transitional period. This would maintain a link to the information that Canadian investors have been accustomed to receiving. Whether and when the transitional period would end should be determined by the regulators, who should take into account whether eliminating the requirement for reconciliation would raise significant comparability issues for analysts and investors.

We received some comment letters which suggested that reconciliation should be required on an ongoing basis until such time as Canadian and U.S. GAAP are harmonized or IAS are more formally adopted in Canada.[69] In this regard, the commenters believed that requiring an ongoing reconciliation from U.S. GAAP financial statements to Canadian GAAP would not be unduly burdensome from a cost perspective, particularly since the differences between U.S. and Canadian GAAP are decreasing. While we believe that ongoing reconciliation may be appropriate for some Canadian companies because of comparability concerns, we believe that this end can be achieved through good management and pressure from the investing community. We prefer that market forces dictate the "right" result rather than imposing ongoing reconciliation through regulation.

Finally, we recognize that the Enron crisis has raised some questions about U.S. GAAP. For example, some observers believe that prescriptive U.S. accounting rules have fostered a "check the boxes" mentality, whereby people focus on technical compliance. These issues are being studied by various groups in the U.S. and are being followed closely in Canada.[70] Notwithstanding these legitimate concerns, we believe that it continues to be important for Canadian issuers to be able to stay in step with requirements imposed by U.S. regulations without duplicating efforts for Canadian reporting purposes. Also, despite recent corporate failures in the U.S. we continue to have faith generally in the robustness of U.S. accounting standards.

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[67] See comment letter on Issues List of Michael Tambosso of PricewaterhouseCoopers.

[68] Only one commenter was opposed to the idea of permitting non-SEC registrants to use U.S. GAAP. The commenter was concerned that if all junior issuers were permitted to use U.S. GAAP, there would be widespread material financial reporting errors and omissions (see comment letter of TSX Venture Exchange). We do not share this concern and emphasize that our recommendation is intended to give both domestic and foreign issuers (regardless of whether they are SEC registrants) the flexibility to report in U.S. GAAP. We are not recommending that issuers must report in U.S. GAAP and we very much doubt that companies that do not feel competent enough to report in accordance with U.S. standards will choose to do so.

[69] See comment letters of Royal Bank of Canada, Certified General Accountant Association of Canada, Certified General Accountants of Ontario, and The Canadian Institute of Chartered Accountants.

Recommendations:

1. We strongly encourage the move by both Canadian regulators and standard setters to IAS and hope that Canada will continue to play a role in this area – with the ultimate goal of permitting both domestic and foreign issuers to report under IAS without a reconciliation to Canadian GAAP.

2. We recommend that the Commission and the CSA permit both foreign and Canadian companies to prepare their financial statements in accordance with U.S. GAAP. Issuers who prepare their financial statements in accordance with U.S. GAAP should be required to reconcile the statements to Canadian GAAP during a transitional period. The duration of the transitional period should be determined by the regulators taking into account whether significant comparability issues will arise if no reconciliation is provided.

2.3 Book-Based Settlement and the Indirect Holding System

Legislation in Canada dealing with the holding, transfer and pledging of securities and interests in securities was developed at a time when securities were held under what is referred to as the *direct holding system*. In such a system, owners of securities had a direct legal relationship with the issuer. That is, owners would either be recorded on the issuer's register or be in physical possession of negotiable security certificates. If a holder of a registered certificate wished to transfer or pledge its interest in securities, it endorsed the certificate, usually in blank, to the purchaser or the pledgee. The purchaser might, in turn, surrender it to the issuer for a new certificate, whereupon the issuer would amend its records to show the purchaser as the registered holder of the certificate. In the case of a pledge of securities, the pledgee either held the certificate to prevent the pledgor from selling or pledging the security to someone else or required that the pledgee be shown as the registered holder on the issuer's register and that a new certificate be issued to it.

Today, securities held by Canadian investors and by investors in other parts of the world are most commonly held through the *indirect holding system*, sometimes also referred to as the book-based system. Under the *indirect holding system*, a security is not registered in the name of the person who owns that security. Instead, investors' interests in securities are recorded on the books of an intermediary – typically a securities dealer, bank or custodian. The intermediary, in turn, has its interests recorded on the books of another intermediary, and so on up the chain of intermediaries until some intermediary – usually a central securities depository – is either recorded on the issuer's register or is in physical possession of negotiable security certificates.

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[70] For example, the *Sarbanes-Oxley Act of 2002* requires the SEC to conduct a study on the adoption by the U.S. financial reporting system of a principles-based accounting system, including an examination of the feasibility of and proposed methods by which a more principles-based accounting system may be implemented in the U.S.

Most commercial transactions in the securities markets are effected by book entries in securities accounts maintained by intermediaries for their customers. Issues may arise in those transactions concerning the nature of the property interest acquired or the validity of a transfer or pledge. If a purchaser/pledgee is not certain which laws apply to the transaction, or whether those laws clearly and inarguably recognize its property interest, then the purchaser/pledgee will attribute legal risk to the transaction. This legal risk may increase transaction costs or, if the legal risk is deemed unacceptable, cause market participants to avoid the jurisdiction altogether. Also, lack of harmonization of substantive laws and conflicts-of-law can make the transferring and pledging of indirectly held securities between jurisdictions inconvenient and, in some cases, altogether unmanageable.

There is a need for a nationally harmonized (and ultimately globally harmonized) commercial-property law framework to oversee the holding, transferring and pledging of securities and interests in securities. Action has been taken in this regard in many parts of the world, including the U.S. In the U.S., Article 8 of the *Uniform Commercial Code* (UCC), which governs transfers and pledges of securities, was revised in 1994 to deal with securities held through the indirect holding system as well as both certificated and uncertificated securities in the direct holding system. No such changes have been made to legislation in Ontario[71] or elsewhere in Canada. This creates legal uncertainty particularly for Canadian market participants active in cross-border securities trading and pledging transactions. It places them at a competitive disadvantage vis-à-vis market participants in the U.S., the European Union and certain other jurisdictions that have reformed, or are in the process of reforming, their substantive laws and conflict-of-laws rules in this area.[72]

After the enactment of revised Article 8 of the UCC, the Uniform Law Conference of Canada established a committee to study the issue of law reform in Canada. It proposed the adoption of a uniform provincial *Securities Transfer Act* (USTA) in Canada, substantially modelled on UCC revised Article 8. This project has been ongoing for a number of years in Canada. In recent years, a CSA Task Force has become involved in this project, and is overseeing the drafting of the USTA legislation with the help of a consortium of provincial legislative counsel.[73] The need to update the legislation in Canada is clear and compelling. Canadian legislation in this area is currently out of step with legislation in the U.S. and certain other countries. The legal foundation for the holding transfer and pledging of securities is of fundamental importance to the clearing and settlement process, and to efficient and safe capital markets.

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[71] The relevant legislation is the *Business Corporations Act*, R.S.O. 1990, c. B-16 and the *Personal Property Securities Act*, R.S.O. 1990, c. P-10.

[72] The conflicts-of-law problem for the indirect holding system is currently being addressed internationally by the *Hague Conference on Private International Law*, which is developing a proposed multilateral choice-of-law Convention. The CSA has been involved in the Hague Conference project, through the Federal Department of Justice, as part of the Canadian delegation to the Hague Conference, and through IOSCO, which is an interested observer to the project.

Recommendation:

We strongly encourage the Commission and the CSA to continue developing securities transfer legislation modelled on revised Article 8 of the UCC in the U.S. and we urge governments across Canada to ensure that such legislation is adopted on a uniform basis as soon as possible.

2.4 Participation in IOSCO

Securities regulators from around the world have sought to harmonize their approach to regulation through IOSCO.[74] Established in 1975, IOSCO promotes mutual co-operation among members through discussion of matters such as market regulation policies and the development of international standards in securities regulation. Over the years, the Commission has been an active participant in IOSCO.

IOSCO has completed or has work in progress on a range of matters, including:

- a multilateral memorandum of understanding for securities regulators regarding information sharing and co-operation in enforcement matters;
- statements of principles to guide securities regulators in dealing with critical areas necessary for auditor oversight;
- recommendations for securities settlement systems intended to promote the implementation of measures that can enhance international financial stability, reduce risks, increase efficiency and provide adequate safeguards for investors; and
- disclosure standards for cross-border initial public offerings and listing of equity securities.

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[73] The Committee has been advised that the Task Force released for comment in June 2002 to a limited number of government and other key stakeholders a draft of the USTA and working drafts of conforming amendments to Ontario and Alberta personal property security legislation ("PPSA"). The stakeholders included the Uniform Law Conference of Canada PPSA Working Groupand the Canadian Conference on Personal Property Security Law. The Task Force's next step is to publish in provincial securities commission bulletins a consultative draft USTA, together with consequential amendments to PPSA legislation and provincial business corporation acts, extensive explanatory material and a CSA Position Paper. The tentative target date to publish the materials is the middle of 2003.

[74] IOSCO is a worldwide association of regulatory bodies with responsibility for securities regulation and the administration of securities laws. IOSCO aims to foster co-operation among its members, promote high standards of securities regulation, facilitate the exchange of information and encourage the establishment of standards and effective surveillance of international securities transactions. For more information, see the IOSCO website at www.iosco.org.

IOSCO is not a global securities regulator, nor does it have any authority to adopt and implement binding international regulatory principles. While the establishment of a true global securities regulator has intuitive appeal given the nature of today's capital markets, we believe that the practical approach for dealing with globalization is to increase the degree of collaboration and co-operation between securities regulators in different countries.

Recommendation:

We encourage the Commission to continue its ongoing participation in IOSCO initiatives and urge the Commission to adopt, in a timely fashion, changes to its rules to implement the international standards emanating from IOSCO.

SECURITIES REGULATION – ONLY PART OF THE CAPITAL MARKETS PICTURE

3.1 History of Regulation of Financial Markets in Canada

Until 1987, regulation of Canadian financial markets was based on the "four pillars" structure of financial services delivery. Institutions forming each of the four pillars had the exclusive right to provide a core financial service. Banks offered loans and accepted deposits; insurance companies sold insurance; trust companies provided estate and trust services and offered mortgages; and securities firms underwrote public offerings and sold securities to the public.[75] There was little overlap between products and services, and each pillar was governed by its own legislation and regulator.

The rules separating the four pillars were eliminated in 1987[76] and each of the four types of providers began to offer products and services in areas from which they previously had been excluded. Notwithstanding this change, each type of institution (and the products and securities they offer) continues to be regulated by its own statute. As a result, similar activities or products are regulated in a different fashion depending on the nature of the financial institution offering the product or service.

For example, mutual funds and segregated funds are functionally equivalent from the viewpoint of the investor. Each is a managed pool of funds that is invested in a variety of instruments including debt instruments and equity. Mutual fund units or shares are securities and are therefore governed by securities regulation. They are subject to very detailed rules regarding: how they are structured and organized; disclosure with respect to the product, which must be pre-cleared by securities regulators and given to purchasers; conflicts of interest for portfolio managers of mutual funds; and fees which must be disclosed to purchasers. Segregated funds, on the other hand, are structured as contracts of insurance and therefore are not considered "securities" for purposes of the Act. They are instead governed by the requirements of the *Insurance Act*[77] and are not subject to the same type of regulation with respect to disclosure, conflict of interest, sales practices and fees as are mutual funds. A retail investor may buy an interest in both a mutual fund and a segregated fund and, despite the similarity of the products, receive different types of protection.

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[75] David A. Brown, Q.C., *After MacKay: Re-aligning Financial Services Regulation. A Framework for Market Regulation in Canada* (Remarks given at the Securities Superconference, February 24, 1999).

[76] The Hockin-Kwinter Accord of April 28, 1987 between the Minister of Finance of Canada and the Minister of Financial Institutions for the Province of Ontario introduced a new regime for the regulation of federal financial institutions (banks, federal trust and loan companies, and federal insurance companies) and their subsidiaries and affiliates.

[77] R.S.O. 1990, c. I.8.

The regulation of portfolio managers is another example. Portfolio managers buy and sell securities for their clients on a discretionary basis. Their clients are pension funds, estates, mutual funds, segregated funds and private clients. While their function is the same for all types of clients, the standards and requirements imposed on portfolio managers are significantly different, depending on where the portfolio manager works. Portfolio managers licensed by the securities commissions are subject to the highest standards of education and experience of any category of registration under securities legislation. On the other hand, trust company employees making investment decisions for estates and pension administrators investing pension funds are not subject to any proficiency requirements under federal or provincial financial institution or pension legislation. The rules designed to protect clients from conflicts of interest in the portfolio manager's investment decision-making, and those governing the conduct of the portfolio manager in the market (such as prohibitions on "front-running" client orders) differ substantially depending upon whether the portfolio manager is registered under securities legislation or is governed by trust or pension legislation.[78]

Finally, considerable regulatory uncertainty exists concerning the regulation of trading in securities by pension plans. In Canada, there has been a move away from defined benefit plans (in which the employer is responsible for operating the plan, investing its assets, and paying a defined monthly benefit to eligible pensioners), toward defined contribution pension plans (DC) or group registered retirement savings plans (RRSP). In some DC plans and in group RRSPs, the employee makes the decision about how to invest his or her portion of the plan assets, choosing from a range of investment options made available by the plan sponsor. It is the employee who bears the risk of the investment decision in terms of what the employee's ultimate pension benefit will be.

Current securities legislation provides that securities can be sold to a pension plan without having to comply with the prospectus and registration requirements of the Act if the securities are sold by a financial intermediary directly to the plan or its sponsor and there is no communication with or disclosure to the employees.[79] This exemption may have made sense for defined benefit pension plans, where the plan administrator often retained qualified money managers to manage the investments of the plan and the employee was not making any investment decision, such that the protections of the Act were considered unnecessary. However, the Committee believes that the approach to regulating DC plans and group RRSPs should be revisited to ensure that employees who make their own investment decisions receive adequate disclosure and investor protection.

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[78] *A Framework for Market Regulation in Canada – A Concept Paper Prepared for the Canadian Securities Administrators* (1999), 22 OSCB 1290.

[79] OSC Rule 32-502 *Registration Exemption for Certain Trades by Financial Intermediaries*.

3.2 The Current Regulatory Response - Functional Regulation

A) BACKGROUND

On February 24, 1999, the CSA issued a concept paper entitled "A Framework for Market Regulation in Canada" (the "Concept Paper").[80] The Concept Paper began by reviewing the historical basis for regulation in Canada and noted the regulatory mismatches that have arisen because of the continuing institutional nature of regulation in Canada. The Concept Paper advocated a move toward a "functional mode of regulation":

> Clearly, the framework [for regulation] should be improved and all levels of government should expand their initiatives to eliminate unnecessary duplication and overlap in the regulatory system. However, the nature and degree of the mismatches in the system lead to the conclusion that there is a need for something more than incremental improvements. It is time for a more comparable regulatory treatment of similar market services and products regardless of the way in which those products and services are packaged or the nature of the institution offering them. In Canada a more effective regulatory framework for the financial services industry would be achieved by moving to a functional mode of regulation. Functional regulation allocates regulatory responsibilities along regulatory objective parameters: usually divided between prudential regulation and market (or consumer protection) regulation.[81]

The focus of functional regulation is on activities and particular products rather than on the nature of the institutions that carry on the activities or offer the products or services. Functionally equivalent or similar products and services are given similar regulatory treatment even when they are provided by very different entities.[82] The Concept Paper would have vested market regulation for all financial services providers in the provinces and territories. The provincially based market regulators would be responsible for oversight of market conduct, integrity of markets and consumer protection including:

- consumer protection regimes applicable to all financial institutions;
- market integrity rules governing market conduct of all participants in securities markets;
- the regulation of securities, derivatives and futures markets; and
- oversight of industry SROs.

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[80] *Supra* note 78 at 1299.

[81] *Supra* note 78 at 1292.

[82] *Supra* note 78 at 1301.

B) PROVINCIAL INITIATIVES

On September 8, 2000, the Ministry of Finance released a discussion paper entitled "Improving Ontario's Financial Services Regulation: Establishing a Single Financial Services Regulator – a Discussion Paper."[83] Among other things, this discussion paper proposed a merger of the Commission and the Financial Services Commission of Ontario. This merger would effect a form of functional regulation similar to that proposed by the CSA in the Concept Paper. The merged entity, the Ontario Financial Services Commission, would regulate securities, pension, insurance and other financial services sectors in Ontario and would provide a level playing field with respect to disclosure, proficiency, market conduct and market integrity for participants in these markets in Ontario.[84]

On December 11, 2002, the Quebec government passed Bill 107, which will consolidate financial services regulation in the province under a new super-agency, the Agence d'encadrement du secteur financier du Québec. The new agency will replace five provincial agencies, including the Commission des valeurs mobilières du Québec, that now oversee all areas of the province's financial sector, including insurance products, securities, mutual funds and retirement savings.

On July 10, 2002, the Saskatchewan government passed the *Saskatchewan Financial Services Commission Act*. The act created the Saskatchewan Financial Services Commission, effective February 1, 2003, which integrates the three major organizations that regulate financial services in Saskatchewan: the Saskatchewan Securities Commission, the Financial Institution Section of the Consumer Protection Branch and the Pension Benefits Branch of the Saskatchewan Department of Justice.

C) JOINT FORUM OF FINANCIAL MARKET REGULATORS

The CSA, the Canadian Council of Insurance Regulators and the Canadian Association of Pension Supervisory Authorities established the Joint Forum of Financial Market Regulators (the "Joint Forum"). This is a national forum of pension, securities and insurance regulators established to discuss common issues arising from the growing integration of the financial services sector. In its fall 2000 newsletter, the Joint Forum indicated its intention to focus on regulatory harmonization in the following areas:

- proficiency requirements for financial planners;
- individual variable insurance contracts [segregated funds] and mutual funds;

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[83] Ontario, Ministry of Finance at http://www.gov.on.ca/FIN/english/pubseng.htm.

[84] In April 2001, the Ministry of Finance released for comment a Consultation Draft of the proposed merger legislation. Comments were due June 29, 2001. At the same time, it should be noted that FSCO is moving away from prudential regulation of insurance companies in Ontario. Effective July 1, 2004, all loan and trust companies wishing to carry on business in Ontario will be required to be federally incorporated and subject to solvency regulation by OSFI, at the

- investment disclosure in capital accumulation plans [i.e., defined contribution, group RRSP, deferred profit sharing]; and
- intermediary proficiency and licensing.

On April 27, 2001, the Joint Forum released for comment a consultation paper on capital accumulation plans, which proposed broad regulatory principles for disclosure and other regulatory protections for capital accumulation plans.

D) INTERNATIONAL TRENDS TOWARD FUNCTIONAL REGULATION

Finally, on an international level, the Committee notes that in 1999 Australia brought all financial institutions under the supervision of three regulators: the Australian Securities and Investments Commission (which regulates market conduct of members of the securities, banking, insurance and pension industries), the Australian Prudential Regulation Authority and the Reserve Bank of Australia. Meanwhile, in the U.K., the FSA has become the sole regulator of the financial services industry.

3.3 One Step Further – Harmonized Functional Regulation

In the Committee's view, the ideal regulatory model in Canada would be one of "harmonized functional regulation." This combines the harmonization of securities regulation across the country as recommended in Chapter 1 and functional regulation as discussed above. While harmonized national securities regulation will result in a rationalized approach to regulating the securities industry in Canada, it will not eliminate the current inconsistencies discussed above in regulating functionally similar products and services. It is therefore also desirable, in our view, to pursue the harmonization of functional regulation nationally, once a single securities regulator has been established. This would result in all products, services and activities in the financial services sector being regulated identically across the country, regardless of the entity which offers the product or service or engages in the activity.

In our Draft Report we proposed a model of harmonized functional regulation in which regulation would distinguish between market conduct and products, on the one hand, and prudential issues on the other. Market activities would be regulated by one market conduct regulator and by one prudential regulator. All products and services, and the behaviour and conduct of those manufacturing and selling them, would be under the regulatory jurisdiction of the market conduct regulator. This regulator could continue to rely on recognized SROs as appropriate.[85] All matters relating to fiscal solvency of the institutions would fall under the

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federal level (See *An Act to implement measures contained in the 2001 Budget and to amend various statutes*, S.O. 2001, c. 8, section 75).

[85] To the extent both the prudential branch of the regulator and an SRO were to regulate solvency matters of a participant, we would hope there would be co-ordination between the regulator and the SRO to ensure there is no duplicative or inconsistent regulation.

auspices of a prudential regulator. This is the model that has been adopted in Australia. This is contrasted with the model adopted in the U.K., which brings market and prudential regulation under the auspices of a single regulator – the FSA.

We received a number of comments on our recommendation that there be a move to adopt a harmonized system of functional regulation.[86] Some commenters felt that harmonized functional regulation was a laudable objective but they believed it could only occur after a single securities regulator was in place.

Other commenters discussed our model, which proposed a separate market conduct regulator and a separate prudential regulator. The Ontario Teachers' Pension Plan agreed there must be a distinction between market conduct on the one hand and prudential regulation on the other but noted that "in both cases there should be a move towards the unification of each of the regulating groups."

The IDA had a very different view on whether the two regulatory functions should be vested in separate regulators:

> It is noteworthy that while many of the Committee's recommendations have as their objective more integrated seamless regulatory structures, the Committee recommends the fragmentation of market conduct and fiscal solvency regulation. The IDA as a national securities market conduct and fiscal solvency regulator has a unique perspective on this issue. It has been our experience that market misconduct is sometimes associated with the deteriorating financial health of the firm. The market conduct and fiscal solvency examinations are an important source of risk assessment data which is a prerequisite for preventative, forward looking regulatory intervention. In addition, it is interesting to note that the NASDR and NYSE are both a market conduct and fiscal solvency regulator and indeed they make no organizational distinction between the two areas. It is our belief, supported by our experience that market conduct and fiscal solvency regulation are more effective if done in an integrated fashion.

We acknowledge that in practice there is rarely a clean separation between market conduct regulation and prudential regulation. We also acknowledge the IDA's point that, at least at the SRO level in Canada, both functions are combined within the one SRO and this is desirable given the synergies it creates. We are mindful that our recommendations for restructuring the financial services regulatory framework must be practical. In this Final Report, while we recommend a single securities regulator, we have not proposed a model by which we believe a single securities regulator should be achieved. If it is achieved by a federal body being established, then harmonized functional regulation could occur within one body by bringing the current prudential regulator, OSFI, into the federal securities regulator (or by merging them). If, however, a single securities regulator is achieved by a pan-provincial solution, it would be more difficult to merge this entity with OSFI. Ultimately our vision for harmonized functional regulation is that there is one set of regulation of all financial services market participants.

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[86] See comment letters of Ontario Teachers' Pension Plan, Investment Counsel Association of Canada, Bank of Montreal, Canadian Bankers Association, Royal Bank of Canada and the IDA.

Market conduct and prudential regulation could be undertaken by a single regulator or may, of necessity, be divided between two regulators. If the latter, we would expect the two regulators to work together very closely both to minimize regulatory duplication and to ensure that the benefits of combined market conduct and prudential regulation identified by the IDA in their submission are fully realized.

The Committee is further aware that a move from the current Canadian model of separate provincial regulation of securities laws, on the one hand, and regulation of insurance companies, pension plans, trust companies and financial institutions, on the other hand, to a fully harmonized and integrated model of regulation cannot occur overnight. Incremental steps need to be taken. During the transition from the current regulatory model to a single securities regulator and then to harmonized functional regulation, we urge continued regulatory co-operation and co-ordination in the financial services field through participation in worthwhile endeavours such as the Joint Forum.

We also recognize that if the proposed OSC/FSCO merger is implemented, it could be more of a challenge to achieve harmonized functional regulation, particularly where other provinces have not adopted a merged structure.[87] We urge those involved in the Commission/FSCO merger process to ensure that the structure they propose is flexible enough to accommodate the establishment of harmonized functional regulation.

Recommendation:

We recommend that the CSA, provincial and territorial governments and the federal government move to adopt a system of harmonized functional regulation across Canada, whereby all Canadian capital market activities, products and conduct are regulated in a similar fashion and are subject to similar standards despite the differences between the various institutions or market participants offering the products or services to the marketplace. In the interim, we encourage continued regulatory co-operation and co-ordination in the financial services area through participation in endeavours such as the Joint Forum of Financial Regulators.

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[87] We note that this issue will be encountered in any event given the recent initiatives in Saskatchewan and Quebec (discussed above in section 3.2(b)).

PART 2

FLEXIBLE REGULATION

In Part 2 of this report, we discuss issues relating to the structure and operations of the Commission, the basic structure of the Act such as its purposes and principles, rulemaking and the impact of the Internet on securities regulation. One of our main concerns is that the regulatory framework be flexible enough to adapt to a changing marketplace while maintaining high standards of investor protection.

THE COMMISSION – ITS STRUCTURE, GOVERNANCE AND ACCOUNTABILITY

In a time when corporate governance of public companies is under intense scrutiny, it is not surprising that some have turned their attention to the structure, governance and accountability of the Commission as the regulator and overseer of Ontario's capital markets. In this chapter we address this issue.

4.1 The Structure of the Commission

In 1994, the Act was amended to change the status of the Commission from that of a government agency to that of a Crown corporation, and in 1997 the Commission obtained "self-funding" status.[88] With these changes, the Commission has achieved greater autonomy and independence from the government.

For the purposes of this chapter it is necessary to distinguish between the Commission and its staff.

A) THE COMMISSION

The Commission is a not-for-profit corporation. The Commission, composed of nine to 14 members known as Commissioners, serves as its board of directors.[89] The Commission is responsible for the administration of the Act.[90] The Commissioners are appointed by the Lieutenant Governor in Council. One Commissioner is designated as the Chair of the Commission and is also the chief executive officer of the Commission and must devote him- or herself full time to the work of the Commission.[91] The Lieutenant Governor in Council may also designate one or two Commissioners as Vice-Chairs.

The Commission and the Minister of Finance are required to enter into a memorandum of understanding every five years setting out:

i) the respective roles and responsibilities of the Minister and the Chair;
ii) the accountability relationship between the Commission and the Minister;

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[88] The Act, subsection 3(12).

[89] The Act, subsection 3.1(1).

[90] The Act, subsection 3.1(2).

[91] The Act, subsections 3(5), 3(7).

iii) the responsibility of the Commission to provide to the Minister business plans, operational budgets and plans for proposed significant changes in the operation or activities of the Commission; and

iv) other matters that the Minister may require.

The final form of the memorandum of understanding must be published in the Bulletin. The first memorandum of understanding was to have been entered into by 1999. To date, no memorandum of understanding has been entered into between the Minister and the Commission.[92]

B) STAFF

The Commission is authorized to employ "such persons as it considers necessary to enable it to effectively perform its duties and exercise its powers under this and any other Act."[93] Staff comprises lawyers, accountants, economists, investigators, managers and support staff. The Commission also establishes advisory committees of stakeholders from time to time to advise it on matters of mutual importance.

4.2 Governance Matters

A) GOVERNANCE STRUCTURE

The Commission discharges many of its responsibilities through committees: the Compensation Committee, the Audit and Finance Committee, and the Corporate Governance and Nominating Committee.[94] The mandate of each committee, and its membership, is available on the website of the Commission at www.osc.gov.on.ca. The members of the committees are non-executive Commissioners except that the Chair of the Commission is an ex-officio, non-voting member of the Corporate Governance and Nominating Committee.

B) OVERSIGHT AND ACCOUNTABILITY

One method by which a corporation ensures that its governance structure is appropriate and it is operating properly is to undertake reviews of its structures and operations. Before the Commission became a Crown agency, its internal controls were established and monitored by the provincial government. When it became a Crown corporation, it began the process of establishing its own internal controls. As part of this process, the Audit Committee commissioned one of Canada's major accounting firms to identify and assess the key risks that may impact the objectives of the Commission and to develop an internal audit plan which would assist the Commission in mitigating these risks. Recommendations were delivered to the Audit Committee in October 2002. Following its review of the recommendations, the Audit Committee retained that accounting firm to continue its work by conducting the internal audit as contemplated by that report. This internal audit project is currently in the first year of its three-year plan.

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[92] While no memorandum of understanding has yet been entered into, we understand one has been substantially negotiated between the Minister and the Commission and that the Commission does, in practice, perform its responsibilities under the memorandum of understanding as if it was in effect.

[93] The Act, subsection 3.6(1).

[94] By-law Number 1 of the Commission authorizes the Commission to establish committees. See section 3.8.

In its recent report[95] the Fraser Institute notes that in the U.S., oversight of the SEC is conducted mainly through both houses of Congress. Each of the House of Representatives and the Senate has a committee whose mandate includes oversight of the SEC. Further, these committees rely heavily on the General Accounting Office (GAO), an independent government agency which studies government programs and spending, to oversee and study aspects of the SEC's operations. In 2001, the GAO released nine reports related to aspects of the SEC's operations.[96]

We believe the Minister and the Commission should consider whether reviews or studies of specific aspects of the Commission's operations, similar to those conducted by the GAO of the SEC, would be beneficial to the Commission and its stakeholders.

Recommendation:

We recommend that the Minister and the Commission consider whether studies of specific aspects of the Commission's operations, similar to those conducted of the SEC by the GAO in the U.S., should be undertaken.

4.3 Transparency

The Act, in section 2.1, sets out the principles for the Commission to consider and apply in carrying out its mandate, including the need for "…timely, open and efficient administration of the Act." The governance of the Commission should serve as an example to those it regulates and oversees:

> the quality of the governance of a regulator contributes towards the competitiveness of a jurisdiction's capital markets. It helps assure market participants that regulatory powers will be used in a reasonable manner and regulatory resources will be used efficiently.[97]

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[95] Neil Mohindra, *The Governance of the Ontario Securities Commission: Lessons from International Comparisons* (Fraser Institute, Public Policy Sources Number 61: August 2002) at p. 13.

[96] *Ibid.* at p. 13. The studies looked at matters such as actions taken to address day trading concerns, human capital challenges, fine collections and disclosure of certain policies to investors.

[97] *Ibid.*at p. 17.

A fundamental aspect of the Commission's accountability is its relationship with the Minister. We strongly encourage the Minister and the Commission to execute the memorandum of understanding between them, and to publish it in the Bulletin.

The goal of transparency in connection with the Commission's structure and operations is further enhanced through the Commission's reporting processes. Section 143.9 of the Act requires the Commission, within 90 days of the end of its financial year, to deliver to the Minister and publish in its Bulletin a statement of the proposed priorities of the Commission in connection with the administration of the Act, the regulations and the rules, together with a summary of the reasons for the adoption of the priorities. This Statement of Priorities also must outline in general terms the Commission's anticipated expenditures for the next financial year by category for any category expected to exceed 10 per cent of the overall expenditures for the year. At least 60 days before the publication date of this statement, the Commission must publish a notice in the Bulletin inviting interested persons or companies to make written representations as to the matters that should be identified as priorities. The Statement of Priorities is published in the Bulletin and posted on the Commission's website when finalized. The Commission also reviews annually its performance against its past objectives in either its Annual Report, which is also published and sent to certain market participants, or the Statement of Priorities.

We are encouraged by recent measures and initiatives the Commission has undertaken to increase transparency in connection with its governance and accountability structure. The website of the Commission now contains a section entitled "Governance and Accountability." The section discusses the structure of the Commission and identifies its committees, their mandates and members. We also note and strongly support the Commission's commitment to continue to enhance the information it provides on its website in this regard.

4.4 The Many Roles of the Commission

The Commission is a multi-functional administrative agency. It discharges a number of different and overlapping roles at the same time, including making policy, conducting investigations and sitting as an administrative tribunal.

We have considered whether the structure of the Commission, which permits it to develop policy, conduct investigations and adjudicate issues which come before it, should be modified. We reviewed the structure of other administrative tribunals in Canada, and of securities regulatory authorities in Canada, the U.S., the U.K. and Australia.[98] We have also considered the case law in Canada concerning the functions of administrative tribunals.[99]

The structure of the Commission, combining both regulatory and adjudicative functions in one administrative agency, is neither unique to the Commission nor contrary to the common law doctrine of reasonable apprehension of bias. The Supreme Court of Canada has considered multi-functional administrative agencies similar to the Commission on several occasions, and has consistently held that if the multiple functions are authorized by statute (as they are in the case of the Commission), the administrative tribunal cannot be attacked on grounds of reasonable apprehension of bias, solely because the structure, albeit statutorily authorized, expressly authorizes and directs it to perform overlapping functions.

The question, then, is not whether the current structure is permissible, but whether it is one which gives rise to perceptions of potential for conflict or abuse.[100] This is a complex issue. There are advantages and disadvantages to both an integrated tribunal with "overlapping functions" as well as a bifurcated model where the investigative and adjudicative functions are performed by separate entities. We make no recommendation on this issue at this time other than to note that because the structure of a multi-functional agency can give rise to perceptions of potential for conflicts or abuse, the current structure of the Commission merits further thought and study on a priority basis.

Recommendation:

We recommend that the current structure of the Commission as a multi-functional agency be given further thought and study by the Commission and the Minister on a priority basis.

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[98] In the U.S., hearings brought by the SEC are heard in the first instance by administrative law judges. At first blush it would appear that the SEC has completely separated its regulatory from its adjudicative functions. However, the administrative law judges are SEC employees, and their decisions are appealable to the SEC.

[99] *Brosseau* v. *Alberta (Securities Commission)* [1989] 1 S.C.R. 301; *E.A. Manning Ltd*. v. *Ontario Securities Commission* (1995), 23 O.R. (3d) 257 (C.A.); *Ocean Port Hotel Ltd*. v. *British Columbia (General Manager, Liquor Control & Licensing Branch*) 2001 SCC 52.

[100] We note that a Commissioner who has signed an investigation order under Part VI of the Act is prohibited from sitting on a hearing dealing with the matter in question (subsection 3.5(4) of the Act). This provision ensures that the Commissioners who perform a quasi-adjudicative function with respect to a matter are not biased. Furthermore, aside from signing an order under Part VI, Commissioners are not otherwise involved in the investigation process.

OBJECTIVES OF THE ACT

5.1 Purposes of the Act

The Act sets out two purposes (the "Statutory Purposes"):

> 1.1 The purposes of this Act are,
>
> (a) to provide protection to investors from unfair, improper or fraudulent practices; and
>
> (b) to foster fair and efficient capital markets and confidence in capital markets.

We considered whether the purposes set out in the Act continue to be appropriate. In doing so, we reviewed comparable provisions (to the extent they exist) in securities legislation in the U.S., the U.K. and Australia.[101] We are satisfied that section 1.1 provides the Commission with a mandate that is appropriate and largely consistent with the mandate of other foreign securities regulators.

5.2 Principles to Consider

The Act directs the Commission to have regard to the following six fundamental principles in pursuing the Statutory Purposes (the "Principles Clause"):

> 2.1 In pursuing the purposes of this Act, the Commission shall have regard to the following fundamental principles:
>
> 1. Balancing the importance to be given to each of the purposes of this Act may be required in specific cases.
>
> 2. The primary means for achieving the purposes of this Act are,
>
>   i. requirements for timely, accurate and efficient disclosure of information,
>
>   ii. restrictions on fraudulent and unfair market practices and procedures, and

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[101] Both the U.K. and Australian regulatory regimes have recently undergone a very thoughtful process of review and revision.

iii. requirements for the maintenance of high standards of fitness and business conduct to ensure honest and responsible conduct by market participants.

3. Effective and responsive securities regulation requires timely, open and efficient administration and enforcement of this Act by the Commission.

4. The Commission should, subject to an appropriate system of supervision, use the enforcement capability and regulatory expertise of recognized self-regulatory organizations.

5. The integration of capital markets is supported and promoted by the sound and responsible harmonization and co-ordination of securities regulation regimes.

6. Business and regulatory costs and other restrictions on the business and investment activities of market participants should be proportionate to the significance of the regulatory objectives sought to be realized.[102]

We identified the following additional considerations which are set out in securities regulation in other jurisdictions which we discuss below:

- promoting the informed participation of investors in the marketplace;
- maintaining the competitive position of Ontario in light of the international character of capital markets;
- facilitating innovation in connection with regulated activities; and
- facilitating competition among regulated market participants.

A) PROMOTING THE INFORMED PARTICIPATION OF INVESTORS IN THE MARKETPLACE

Individual Canadians are investing in the capital markets in increasing numbers.[103] With access to on-line research, advice and trading, individuals are becoming more directly involved in managing their own investments. In this environment, investor education has taken on a new importance. Retail investors face a bewildering array of choices. To invest wisely they need to understand the basics of investing and saving, know how to evaluate an investment or salesperson, and know how to protect themselves against possible fraud. We therefore recommend as reflected below that the Act be amended to incorporate in the Principles Clause the principle that effective and responsive securities regulation should promote the informed participation of investors in the marketplace. We note that the Commission has devoted considerable attention and resources to investor education in recent years.[104]

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[102] Sections 1.1 and 2.1 of the Act were enacted pursuant to the 1994 Amendments on the recommendation of the Daniels Committee. Section 2.1 was enacted as a result of concerns that there would be little to gain from having just a mandate section predicated on broadly defined purposes. Section 2.1 lists several principles that both "common sense and the actual practices of the Commission dictate should be and have been used to direct and structure the Commission's interpretation of the Act's purposes in the context of specific cases, problems and regulatory initiatives." See the Daniels Report, *supra* note 11 at page 3235.

[103] "Roughly one half of all working Canadians are directly and indirectly invested in the equities market. Over the past ten years, Canadian investors' holdings of securities have doubled to more than $550 billion today. Ten years ago, 22 per cent of the average investor's financial assets (bank accounts, RRSPs, pension, insurance, etc.) were stocks. Today this share has grown to 30 per cent." (IDA, *Canadian Securities Industry Profile* (http://www.ida.ca/indissues/indprofile.en.asp)).

B) ONTARIO'S PLACE IN GLOBAL CAPITAL MARKETS

In Part I of this report, we discussed the importance of Canadian capital markets being competitive on a global basis. Globalization of financial services, coupled with advances in information technology, mean investors are no longer geographically bound. Cross-border, 24-hour trading is already commonplace. If our markets are healthy and vibrant, investors will choose Canada. If our markets do not measure up to international standards, investors will bypass Canada and seek quality elsewhere. We therefore recommend as reflected below that the Act be amended to incorporate in the Principles Clause the principle that capital markets are international in character and it is desirable to maintain the competitive position of Ontario's capital markets.

C) FACILITATING INNOVATION

In recent years we have seen the development of new technologies, new financial products, new market participants and new trading methods. Such financial innovations should be encouraged. They reduce costs and enable investors to better manage their money. Regulators should work with the securities industry to facilitate innovation. In particular, participants should be encouraged to discuss new product ideas and new market developments with the regulators at an early stage to ensure that the risks and regulatory implications are properly understood and managed. Similarly, regulators should avoid unreasonable barriers to entry or restrictions on market participants launching new products. We therefore recommend as reflected below that the Act be amended to incorporate in the Principles Clause the principle that innovation in Ontario's capital markets should be facilitated.

D) COMPETITION AMONG MARKET PARTICIPANTS

Competition among market participants is the main engine for innovation and in general works to consumers' best interests. The Commission should seek to ensure that its rules and policies do not impede or distort competition. In particular, it is important to maintain a level playing field among all market participants. We therefore recommend as reflected below that the Act be amended to incorporate in the Principles Clause the principle that the administration and enforcement of Ontario's securities law should not unnecessarily impede or distort competition among persons carrying on regulated activities.

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[104] For example, the Commission participates, along with other members of the Council of Securities Regulators of the Americas, in an annual "Investor Education Week" to heighten public awareness of the capital markets, the role of regulators and the information resources available to investors. In June 2000 the Commission also established the Investor education Fund to develop and support initiatives that educate investors.

These recommendations appeared in the Draft Report. All the comments we received on these recommendations following the release of the Draft Report were supportive,[105] although one commenter was concerned that the additional principles may "make the Act unwieldy."[106] In particular, the commenter questioned, "How should the Commission prioritize the various principles?" We do not believe that it would be advantageous for us to prioritize the various principles for the Commission, because different principles will vary in importance in different situations. Many of the principles complement one another and the Commission should consider them together when exercising its statutory mandate. We recognize that, in practice, there may be tensions between the different principles and that balancing these principles will not always be easy. We believe, however, that it should be left to the Commission to balance and prioritize competing principles as necessary.

Recommendation:

We recommend that the Principles Clause be amended to include the following additional principles to be considered by the Commission in pursuing the purposes of the Act:

- Effective and responsive securities regulation should promote the informed participation of investors in the capital markets.
- Capital markets are international in character and it is desirable to maintain the competitive position of Ontario's capital markets.
- Innovation in Ontario's capital markets should be facilitated.
- The administration and enforcement of Ontario securities law should not unnecessarily impede or distort competition among persons carrying on regulated activities.

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[105] See comment letters of the Certified General Accountants of Ontario, Ogilvy Renault, Ontario Teachers' Pension Plan, Canadian Association of Insurance & Financial Advisors, and Securities Subcommittee of the Ontario Bar Association.

[106] See comment letter of the Securities Subcommittee of the Ontario Bar Association.

CHAPTER 6

STRUCTURE OF THE ACT

6.1 Should the Act Be Overhauled?

Since the Act first came into force in 1945, it has evolved into a complicated maze of legislation, regulations, rules and interpretative policies. The Act itself is less than 150 pages. However, its provisions must be read together with over 2,000 additional pages of regulations, rules (including national instruments), policy statements, notices, communiqués and clarification notes which restrict the provisions of the Act in some cases and supplement them in others. The result is a fragmented regulatory scheme which is accessible only to highly specialized practitioners.

The Committee considered whether Ontario should abandon the current Act and start again, this time adopting a more streamlined approach to securities regulation. This could be accomplished, for example, by enshrining broad principles and standards of market behaviour (together with enforcement authority) in the statute, with detailed requirements set out in rules that would be subject to ministerial approval. An exercise of this nature would only make sense if it could be done in the context of a national initiative. We are concerned that an overhaul of the Act in Ontario alone would exacerbate the differences in legislation that already exist across the country.[107]

Rulemaking has introduced increased flexibility into our system of regulation. It has made Ontario securities law easier to develop, adopt and amend. Accordingly, we recommend that future legislative initiatives move in the direction of broad principles being enshrined in the Act and detailed requirements contained in the rules. Although we make some recommendations to streamline further the rulemaking process, the ability of the Commission to make rules, if combined with some housecleaning of the Act, will move us significantly toward a more manageable set of regulations, particularly if the CSA's uniform securities law project achieves its objective. We support the efforts of participants in this project and believe that it is important that in drafting uniform legislation, they will take into account the recommendations of this Committee.

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[107] As we discussed in Chapter 1, we believe that Canadian securities regulators should move toward greater harmonization.

6.2 Enshrining Core Concepts

Concepts that are fundamental to securities regulation should be enshrined in the Act. Some already are, but others are buried in the regulations. For example, the Act itself provides that a person must be registered to trade a security or act as an adviser; a prospectus must be prepared in order to distribute securities to the public; minority shareholders cannot be excluded from a take-over bid; public companies must provide certain information to their shareholders; and insiders may not misappropriate material undisclosed information for their own benefit. However, the concept that registered dealers and advisers "deal fairly, honestly and in good faith with clients" is not set out in the Act, although this must surely be considered a cornerstone of securities regulation in Ontario. This principle is contained in a rule.[108] The Committee believes that principles as fundamental as this should be enshrined in the Act. Furthermore, the detailed requirements that support the fundamental concepts of the Act should be moved from the Act to the rules. For example, the Act could provide that all exemptions from the prospectus requirement are prescribed by rule. This will ensure the Act remains a more manageable piece of legislation and will allow the Commission to amend the detailed requirements more easily to respond to changing circumstances in the marketplace.

6.3 Housekeeping Amendments

The Act is cluttered with outdated provisions that have been superseded by rules. One example is the exemption from the prospectus requirement available for trades made by an issuer of its own securities with its employees. There is an exemption for such trades in the Act.[109] However, there is also a rule[110] which eliminates this exemption and replaces it with a different exemption and conditions for using that exemption. Yet, on a plain reading of the Act, one would not be aware of the existence of the rule which fundamentally varies the exemption contained in the Act and the circumstances in which it is available. In situations such as these, the Act should be amended to reflect the fact that the Act has effectively been amended or supplemented by a rule. Such housekeeping amendments should be included in the Minister's legislative agenda on a regular basis.

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[108] OSC Rule 31-505 *Conditions of Registration*, subsection 2.1(2).

[109] The Act, clause 72(1)(n).

[110] OSC Rule 45-503 *Trades to Employees, Executives and Consultants*.

6.4 Plain English

The Committee believes Ontario securities law should be written in a style that is clear and easy to understand. As part of the Reformulation Project, proposed instruments must be accompanied by explanatory notices and Companion Policies; these notices and Companion Policies provide an opportunity for accessible explanations both of changes to the regulatory regime and of new regulatory initiatives. We understand that the CSA has embarked on a plain language initiative and we encourage these efforts.

Recommendations:

1. We recommend that the Act be amended to the extent necessary to ensure that the basic principles relevant to securities legislation are contained in the Act.

2. We recommend that the Commission, together with the Government of Ontario, seek to streamline the Act by incorporating detailed requirements in the rules. In addition, we believe that the Act should accurately reflect current law. This may result in certain exemptions being removed from the Act altogether where they have been superseded by a rule.

CHAPTER 7

RULEMAKING

The Commission was given rulemaking authority in the 1994 Amendments. The Committee reviewed the Commission's rulemaking process and concluded that although the rulemaking process works well, on balance, some refinements should be made to it.

7.1 Background

Prior to 1994, the Commission regularly issued policy statements. These policy statements did not receive legislative or ministerial approval, but were treated as having legal effect, both by the Commission and by capital market participants. In 1993, however, the court in the Ainsley decision found that one of the Commission's policy statements was invalid on the basis that the Commission had "exceeded its jurisdiction under its enabling legislation in promulgating it."[111]

With the validity of policy statements under challenge as a result of this decision, there was a need to find a way to provide these instruments with legislative legitimacy. In October 1993, the Ministry and the Commission established the Daniels Committee. The Daniels Committee recommended that the Commission be given rulemaking authority, subject to appropriate accountability and transparency controls.[112] The Government of Ontario accepted this recommendation and provided the Commission with rulemaking authority as part of the 1994 Amendments.

In response to the Ainsley decision and the 1994 Amendments, the Commission began the process of reviewing all of its existing policy statements, notices and blanket rulings in order to either reformulate them as rules, policies or staff notices or eliminate them. This process is commonly known as the "Reformulation Project."[113] The Commission has also undertaken a number of new rulemaking and policy-making initiatives to keep pace with a changing marketplace. A significant number of the regulatory instruments considered during the Reformulation Project were national instruments; accordingly, securities regulators in other jurisdictions participated in this process. The need to ensure co-ordination among numerous provincial and territorial regulators has made the process more complex and resource intensive. In some cases, this multi-jurisdictional approach to rulemaking has hindered timely and expeditious securities policy-making and regulation.

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[111] In *Ainsley Financial Corporation* v. *Ontario Securities Commission* (1993), 14 O.R. (3d) 280 (General Division), the court declared invalid a Commission policy statement respecting the sale of penny stocks because the Commission exceeded its jurisdiction.

[112] See the Daniels Report, *supra* note 11.

[113] Since 1995, the Commission has reviewed approximately 300 regulatory instruments.

The Reformulation Project is nearing completion. It has been an enormous undertaking not only for the Commission and other members of the CSA, but also for market participants and their advisers who have been operating in a changing regulatory environment and who have been asked to comment on a plethora of both reformulated instruments and new instruments. We expect that the completion of this project will alleviate some of the concerns expressed by market participants in their submissions regarding the number of new rules and policies.

7.2 Scope of Rulemaking Authority

The matters with respect to which the Commission has the authority to make rules are specifically listed in the Act.[114] These "heads of rulemaking power" were intended to provide sufficient authority for the Commission to make rules dealing with those matters that were previously the subject of policy instruments, as well as securities regulatory matters which might arise in the foreseeable future. There is no "basket provision," however, that would allow the Commission to make rules with respect to matters within its legislative mandate but which were not specifically contemplated under the heads of its rulemaking power.

In the absence of a basket provision, the Commission must seek a legislative amendment to the heads of rulemaking authority if it wishes to introduce a rule that is within its legislated mandate, but which does not fall within the specific heads of rulemaking authority set out in the Act. This occurred during the Reformulation Project, when it became apparent that the Commission did not have sufficient legislative authority to support the conversion of certain existing policy statements into rules. These "lack of authority issues" arose in connection with certain prospectus disclosure rules (such as the mutual fund and general prospectus rules) and procedural rules for distributions under a prospectus (such as the prompt offering qualification system and the shelf system).[115]

The Alberta Securities Commission, the BCSC and the SEC each have a basket provision as part of their rulemaking heads of authority. The Alberta Securities Commission is authorized to make rules governing "any other matter related to the carrying out of the Act or the conduct of the business and affairs of the Commission." The BCSC may make rules "for the purpose of regulating trading in securities or exchange contracts, or for the purpose of regulating the securities industry or the exchange contract industry." The SEC is authorized under six different statutes to adopt whatever rules and regulations may be necessary or appropriate to carry out its statutory functions. The reason for such a broad granting of powers was the "imperative to protect investors against fraud or deception made possible by constantly changing conditions."[116]

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[114] For example, the Commission may make rules regulating the listing or trading of publicly traded securities including requiring reporting of trades and quotations.

[115] The Daniels Report stated, for example, that the Commission should receive rulemaking authority to enable it to reformulate former National Policy Statement No. 44 Shelf Prospectus Offerings. However, the head of authority given to the Commission under the 1994 Amendments was not sufficiently broad to capture the entire shelf regime. The Act requires prospectuses to be renewed annually. The shelf regime allows shelf prospectuses to remain in force for two years, after which time they must be renewed. The Commission's rulemaking authority did not permit the Commission to extend the one-year period prescribed by the Act by way of a rule. As a result, in Ontario, amendments were made to the Commission's rulemaking authority in December 1999 to permit proposed National Instrument 44-101 *Shelf Distributions* to be adopted without the need for issuers to apply for and obtain discretionary relief in order for a receipt for a base shelf prospectus to be effective for more than one year.

We understand that commenters to the Daniels Committee opposed the inclusion of a basket provision in the heads of rulemaking authority out of concern that the authority of non-elected officials to make binding law had to be specifically circumscribed. Notwithstanding these comments, the Daniels Committee recommended in its final report that the Commission be given the authority to make rules "respecting any other matter authorized by or required to implement any provision of this Act."[117] The Government of Ontario did not accept this recommendation.

In our Draft Report we recommended that basket rulemaking authority be added to the rulemaking provisions in the Act. Some commenters on the Draft Report were concerned that basket rulemaking authority would give the Commission virtually unfettered rulemaking authority.[118] We believe that there must be a balance between legitimate concerns relating to legislative authority and the need for regulatory responsiveness and flexibility. Piecemeal legislative amendments to broaden the heads of rulemaking authority unnecessarily slow down the rulemaking process. We note that any rule proposal must relate to the purposes of the Act and is subject to a public notice and comment period and Ministerial review and approval. These provisions should act as effective checks to ensure that the Commission acts within the proper scope of its basket rulemaking authority. Future five-year reviews would also afford an opportunity to consider whether the Commission has exercised this authority appropriately.

In the Draft Report our recommendation stated that the Commission should be given the authority to make rules respecting any matter that, *in the opinion of the Commission*, is necessary or advisable for carrying out the purposes of the Act. We have deleted the phrase "in the opinion of the Commission" to remove the subjectivity of the determination from the test so that reliance on the basket rulemaking authority is reviewable. This should alleviate certain concerns expressed to us about giving the Commission this basket rulemaking authority.

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[116] *R.A. Holman & Co., Inc.* v. *SEC* [1962] 2999 F.2d 127, 132 (D.C. Cir.) cert. denied, 370 U.S. 911, quoted in L. Loss and J. Seligman, *Securities Regulation*, 3rd ed. (Boston: Little, Brown & Company, 1993) at 4915.

[117] The Daniels Committee also considered a broader formulation that would authorize rules respecting any matter that, in the opinion of the Commission, was "necessary or advisable for carrying out the purposes and provisions of the Act." The Daniels Committee noted that provisions of this type are frequently found in regulation-making provisions of Ontario and federal statutes. Ultimately, the Daniels Committee recommended the narrower formulation, although we note that this recommendation was never picked up in the 1994 Amendments. In reaching its recommendation, the Daniels Committee gave the following reasons:

- the Commission's heads of authority are intended to be comprehensive, both in terms of the number of matters listed and in terms of the scope of the rulemaking authority that is provided for with respect to the listed matters;
- a responsibly limited basket provision would be more consistent with the innovation of the Commission's rulemaking versus a more broadly drafted provision; and
- periodic resort to the legislature for amendments to the Commission's heads of rulemaking authority is expected and desirable. (The Daniels Report, supra note 11 at page 3255.)

[118] See comment letters of Simon Romano, the Independent Financial Brokers of Canada, the Canadian Association of Insurance & Financial Advisors, and the Securities Subcommittee of the Ontario Bar Association.

We also understand that some CSA jurisdictions with basket rulemaking authority do not, in practice, rely on such authority for rule proposals. This practice appears to be based on a belief that a general rulemaking grant is ineffective where it is coupled with a list of specific heads of rulemaking authority. We are not aware of the basis for this belief nor have we found any support for this position in principles of statutory interpretation and administrative law. We would nonetheless suggest that if our recommendation is adopted by the Government of Ontario, particular attention be paid to this issue at the legislative drafting stage to ensure that the Commission is able to effectively use the proposed basket rulemaking authority.

Recommendation:

We recommend that the Act be amended to give the Commission "basket" rulemaking authority that is substantially identical to that conferred on the Lieutenant Governor in Council pursuant to clause 143(2)(b) of the Act. The Commission should be given the authority to make rules respecting any matter that is "necessary or advisable for carrying out the purposes of the Act."

7.3 The Need to Streamline the Rulemaking Process

Rulemaking permits flexibility and responsiveness in securities policy making and regulation. In general, the comments made to the Committee have been supportive of the Commission's rulemaking authority and believe that rulemaking is an effective regulatory tool.[119] There is, however, concern with the time required to make a rule.[120] It generally takes a minimum of 18 months to put a national or multilateral rule in place. Changes occur in the markets much more quickly than that. Ontario needs to adopt a more streamlined rulemaking process, subject to maintaining appropriate accountability and transparency controls.

A) LENGTH OF COMMENT PERIOD AND MINISTERIAL APPROVAL

In our Draft Report, the Committee considered what improvements could be made to streamline the rulemaking process. We noted that Alberta and British Columbia each has a rulemaking process similar to that in Ontario, with certain important differences: the length of the comment period and the process for obtaining Ministerial approval.[121] We therefore considered whether conforming the rulemaking process in the Act to the approach in either of these provinces would achieve our streamlining objective and facilitate the adoption of harmonized regulation across the country without compromising the public consultation process or the prerogative of the Minister to consider the Commission's regulatory initiatives. In this context, we made two recommendations including that:

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[119] See comment letters on the Issues List of the Alberta Securities Commission, the Ontario Teachers' Pension Plan, the IDA, Torys LLP, TSX Venture Exchange, Canadian Institute of Chartered Accountants, Osler, Hoskin & Harcourt LLP, Simon Romano, Glorianne Stromberg, the Canadian Association of Insurance and Financial Advisors, and the BCSC.

[120] See comment letters on the Issues List of the IDA, Torys LLP, TSX Venture Exchange, and the Canadian Association of Insurance and Financial Advisers.

[121] For example, the BCSC must seek ministerial approval in principle prior to publishing a rule and ministerial consent once it has made a rule. The Commission must seek ministerial approval once it has made a rule. The Alberta

- The minimum initial comment period for rules be reduced from 90 to 60 days and that the minimum initial comment period for policies be reduced from 60 to 30 days.
- The period for Ministerial review of rules be shortened from 60 to 30 days.

Most commenters on the Draft Report were opposed to these recommendations.[122] Commenters strongly believe that the net cumulative effect of our proposed recommendations would be to sacrifice full and complete public discussion in the name of expediency. Commenters noted that the costs associated with implementing new regulation can be burdensome and that it is critical to ensure that there is full transparency and a full airing of different views in the rulemaking process. In this regard commenters generally viewed the proposed shortened time frames as unrealistic and inadequate to obtain the proper input from market participants. We have reconsidered our draft recommendations in light of the concerns raised by commenters and have decided not to include them in our Final Report.

In the context of our proposed recommendation in the Draft Report to shorten the time period available for Ministerial review of rules, one commenter raised a concern that the Ministerial review process is being used by lobbyists to "unmake" or "remake" Commission rules.[123] We note that the Daniels Committee's recommendation that the Commission be given rulemaking authority was based on a number of foundational principles, including "the need to preserve an appropriate political responsibility for the system of securities regulation." The Daniels Committee strongly believed that there was a legitimate role for the Government of Ontario on securities-related matters that had broader public policy implications. The Daniels Committee also believed that it was important to have some form of government mechanism to safeguard against arbitrary actions by the Commission. It therefore recommended a form of government review of Commission rules.[124] In making this recommendation, the Daniels Committee cautioned against frequent government disapproval of Commission rules as this would "attenuate the commitment of stakeholders to active participation in the Commission's notice and comment

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Securities Commission does not need to obtain formal ministerial approval either prior to or following the adoption of a rule.

[122] See comment letters of the Independent Financial Brokers of Canada, the Investment Funds Institute of Canada, the Canadian Institute of Chartered Accounts, the Securities Subcommittee of the Ontario Bar Association, Simon Romano, BMO Nesbitt Burns, and the Canadian Bankers Association.

[123] See comment letter of the Nova Scotia Securities Commission.

[124] While the 1994 Amendments required Ministerial approval of Commission rules, the Daniels Report had actually recommended that Cabinet be vested with the explicit statutory power to either disapprove or amend a Commission rule within a disapproval period (See the Daniels Report, *supra* note 11 at page 3229).

process," which the Daniels Committee regarded as the principal forum for public deliberation and debate over securities rulemaking.[125]

We are supportive of the existing Ministerial review process and share the views expressed by the Daniels Committee. The Ministerial review period legitimately provides stakeholders with an opportunity to lobby the Minister if they believe a rule proposal is flawed or if, in their view, the comments they raised during the comment period have not been adequately addressed. However, it is fundamentally important that there be transparency with respect to the issues directly raised with the Minister during the Ministerial review period so that the integrity and transparency of the public notice and comment process are not undermined. In particular, the Minister should indicate the names of commenters who have raised concerns about a particular rule proposal and the nature of the concerns raised. This, in turn, will permit the Commission to satisfy its statutory obligation to make public the fact that a rule has been rejected or returned by the Minister and why.

Recommendation:

We recommend that the Minister indicate the names of commenters who have raised concerns about a particular proposed rule during the Ministerial review period and the nature of the concerns raised. This, in turn, will permit the Commission to satisfy its statutory obligation to make public the fact that a rule has been rejected or returned by the Minister and why.

B) REPUBLICATION FOR COMMENT

In considering what improvements can be made to streamline the rulemaking process, the Committee also considered the existing requirement to republish proposed rules and policies for comment.

The Act requires the Commission to republish a proposed rule or policy for comment if the Commission "proposes material changes" to the rule or policy. This is an objective test. In Alberta and British Columbia, republication is required if the Commission proposes to make an amendment to a proposed rule that the Commission considers to be a material change. In other words, the determination is left to the expert tribunal in British Columbia and Alberta. In the U.S., a subsequent comment period is not required for SEC rules, provided that the final rule is a "logical outgrowth of the rulemaking proceeding when viewed in light of the original proposal and call for comments." The U.S. test provides some guidance to the SEC as to when republication is warranted.

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[125] See the Daniels Report, *supra* note 11 at page 3229.

We found numerous examples of Commission rules and policies that have been republished for comment three or four times.[126] In such cases, it is not unusual for the rulemaking process to take three to four years to complete. It is not clear to us that the benefits of republication always outweigh the resulting delays in the rulemaking process. As a result, in our Draft Report we proposed an alternative approach based on elements of the U.S., British Columbia and Alberta tests for republication, with additional guidance built in. In particular, we recommended that the Act be amended to require that the Commission republish for comment a proposed rule only if the Commission proposes changes to a rule that the Commission considers to be material, having regard to:

(a) the nature of the changes proposed to the rule as a whole; and

(b) whether the final rule is a logical outgrowth of the rulemaking process when viewed in light of the original rule proposal and request for comments.

We further recommended that a similar test be adopted for the republication of policy statements. In making this recommendation, we noted that the Ministerial review process could act as an effective control to ensure that the Commission republishes for comment in appropriate cases. In particular, the Minister has the power to return a rule to the Commission for further consideration and, in this context, could ask that a rule be republished for comment.

We received several comment letters on recommendation. Most commenters were opposed to the subjective element of the proposed test and expressed concern that our proposal could result in significant changes not being republished for comment.[127] Many commenters were supportive, however, of giving the Commission guidance as to when republication is warranted.[128] In response to the comments received, we have removed the subjective element from our recommendation and continue to recommend adding guidance to the Act as to when republication for comment of a rule or policy is warranted.

Finally, to assist market participants in their review of changes to rules and policies, we also recommend that the Commission publish black-lined versions of its rules and policies when (i) making changes to existing rules and policies; and (ii) republishing for comment a proposed rule or policy.

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[126] See for example, the publication history of OSC Rule 31-502 *Proficiency Requirements for Registrants*; OSC Rule 41-501 *General Prospectus Requirements*; OSC Rule 61-501 *Insider Bids, Issuer Bids, Going Private Transactions and Related Party Transactions*; and OSC Rule 91-504 *Over-The-Counter Derivatives*.

[127] See comment letters of the Canadian Bankers Association, the Canadian Association of Insurance and Financial Advisors, and BMO Nesbitt Burns.

[128] See comment letters of the Canadian Association of Insurance and Financial Advisors, the Canadian Investor Relations Institute, Ontario Teachers' Pension Plan, and the Canadian Institute of Chartered Accountants.

Recommendations:

1. We recommend that the Act be amended to require that the Commission republish for comment a proposed rule where the Commission proposes material changes to the rule, having regard to:

    (a) the nature of the changes proposed to the rule as a whole; and

    (b) whether the final rule is a logical outgrowth of the rulemaking process when viewed in light of the original rule proposal and request for comments.

    We further recommend that a similar test be adopted for republication of proposed policies.

2. We recommend that the Commission publish black-lined versions of its rules and policies when (i) making changes to existing rules and policies; and (ii) republishing for comment a proposal rule or policy.

C) CROWDED AGENDA AND PRUDENT IMPERFECTION

We are concerned that the Commission's internal processes slow down the rulemaking process. In this regard, we note the number of initiatives that the Commission has on its policy agenda at any given time and the length of time that it often takes the Commission to complete them. It seems to us that the Commission may be trying to do too much. When rules take years to complete, the problems or inefficiencies they are intended to address continue. We are also concerned that the number of initiatives on the Commission's rulemaking agenda has discouraged capital-market participants from being fully engaged in commenting on proposed rules.

We recommend that the Commission review its procedures to determine where bottlenecks occur. It should then establish internal standards that set out acceptable timeframes for staff to review and respond to comments received on a rule or policy proposal. Staff should report to the Commission annually on its performance against these standards and the Commission should publish these internal standards and report on its performance against such standards.[129]

We received several comments on this recommendation in the Draft Report. All of the commenters strongly supported this recommendation. One comment letter also raised the point that the efficiency of the Commission's policy work could be greatly improved if the Commission did not strive for perfection in their rule proposals. Rather, this commenter emphasized the need to focus on continuous improvement through a succession of goal-oriented, albeit imperfect solutions, that can be adjusted. In particular, the commenter noted:

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[129] See comment letter of Ontario Teachers' Pension Plan, which recommended that the Commission publish its internal rulemaking standards and report on its success in meeting the benchmarks.

> In its quest for perfect solutions the CSA tends to delay the implementation of change until, on occasion, the event which precipitated the need for change, ceases to be topical. An approach which would seek practical, if not perfect solutions would greatly improve the CSA process. Because CSA policy development is frequently delayed there is a tendency to override policy development by granting discretionary relief. ....To avoid this it is critical that the CSA policy development process be made more efficient.[130]

We share the commenter's concern and believe that in order to enhance the timely implementation of policy changes, the Commission and the CSA should be willing to adopt practical, if not perfect, solutions.

Recommendations:

1. We recommend that the Commission limit the number of projects that it takes on and focus its resources on fewer critical policy issues. We further recommend that the Commission streamline its internal rulemaking process by establishing internal standards for the development of rule and policy proposals, including benchmark timeframes for reviewing and responding to comments on a rule or policy proposal. We recommend that the Commission publish these internal standards and report on its performance against such standards.

2. In order to enhance the timely implementation of policy changes, we encourage the Commission and the CSA to be willing to adopt practical, if not perfect, solutions.

7.4 Cost-Benefit Analyses

The Commission is required to publish in the Bulletin a notice of every rule it proposes to make.[131] That notice must include "a description of the anticipated costs and benefits of the proposed rule."[132] Accordingly, both draft and final rules contain a section dealing with costs and benefits. In the past, this disclosure has often been boilerplate, providing a general overview of the benefits of the proposed regulation and certain of its costs. It is common to find the following statement made at the close of such a discussion: "Based on experience to date, the Commission believes that the benefits of the proposed rule justify the costs."[133] Notices have seldom included any empirical data in support of these conclusions. In comparison, the SEC often sets out the specific costs and benefits associated with proposed regulation.[134] The SEC urges commenters to provide empirical evidence to assess whether proposed regulation will promote the efficiency of securities markets and the confidence of capital market participants.[135]

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[130] See comment letter of the Nova Scotia Securities Commission.

[131] The Act, subsection 143.2(1).

[132] The Act, subsection 143.2(2).

[133] See, for example, Notice of Proposed Rule 33-503 *Change of Registration Information, Rescission of Notice and Revocation of Regulations under the Securities Act*, http://www.osc.gov.on.ca/en/Regulation/Rulemaking/Rules/33-503_rule.html (September 17, 1999); Notice of OSC Rule 31-507 "*SRO Membership – Securities Dealers and Brokers*", http://www.osc.gov.on.ca/en/Regulation/Rulemaking/Rules/31-507_oscrule_20000630.html (June 30, 2000).

The Committee believes that, as a general practice before implementing rules, securities regulatory authorities should solicit, commission or conduct empirical studies with the objective of enabling regulators to assess the effectiveness, costs and benefits of the proposed rules. This cost-benefit analysis should include, where possible, a description of background materials and empirical evidence relied on. This affords investors and market participants the opportunity to digest and challenge the Commission's analyses through the comment process and/or provide additional empirical evidence for the Commission's consideration.

The Committee notes that the Commission has recently made improvements in this area. For example, in a recent concept proposal for a new fee structure issued by the Commission, the accompanying Notice included a very helpful economic analysis of the impact of the concept proposal on capital-market participants.[136] We encourage the Commission to continue to include analyses of this nature, and of the type we discuss, in future rules.

However, there will be occasions when it is either unnecessary or infeasible to collect and assess empirical data and to perform the recommended cost-benefit analysis. In some cases, even if it is possible to collect certain data, it may not be possible to conduct a statistically significant analysis with it. In cases where the Commission does not complete more detailed cost-benefit analyses prior to the introduction of new regulation, it should explain why it was not feasible to do so.

Regulation that is not harmonized with securities laws in other CSA jurisdictions can be costly for issuers. Thus, we believe that cost-benefit analyses should also specify whether a proposed rule contributes to harmonizing securities laws across Canada. In particular, the notice accompanying a proposed rule should discuss the expected effect of the new policy or rule on harmonization and co-operation.[137] If adoption of the rule is expected to lessen harmonization or cooperation, the Commission should describe why it should nevertheless be adopted.

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[134] SEC, "Exemption for the Acquisition of Securities During the Existence of an Underwriting or Selling Syndicate", 17 CFR Part 270, Release No. IC-24775; File No. S7-20-00, RIN 3235-AH57, or online at http://www.sec.gov/rules/proposed/ic-24775.html.

[135] A typical statement from an SEC Release requesting comments from capital market participants on a given subject reads, "The Commission requests comment on all aspects of this cost-benefit analysis, including identification of additional costs or benefits of the proposed changes. The Commission encourages commenters to identify or supply any relevant data concerning the costs or benefits of the proposed amendments." See, for example, SEC, "Firm Quote and Trade-Through Disclosure Rules for Options" 17 CFR Part 240, Release No. 34-43085; File No. S7-17-00, RIN 3235-AH96, or online at http://www.sec.gov/rules/proposed/34-43085.htm#link17.

[136] Notice and Request for Comments 11-901 *Concept Proposal to Revise Schedule 1 (Fees) to the Regulation to the Securities Act (Ontario)* (2001), 24 OSCB 1971.

Recommendations:

1. When the Commission is conducting cost-benefit analyses of proposed rules, as required under the Act, we recommend that the Commission conduct or commission empirical studies to assess the effectiveness, costs and benefits of the proposed rule.

2. We recommend that each cost-benefit analysis which the Commission conducts concerning a proposed rule should specify whether a proposed rule contributes to harmonizing securities laws across Canada and should discuss the expected effect of the new rule on harmonization and co-operation. If adoption of the new rule is expected to lessen harmonization or co-operation, the Commission should describe why it should nevertheless be adopted.

7.5 Blanket Rulings and Orders

Blanket rulings and orders[138] are rulings or orders of general application issued by a securities regulator that exempt classes of trades, securities, companies, transactions and other matters from regulatory requirements otherwise applicable.[139] Blanket rulings and orders apply to anyone who fits the terms of the order and obviate the need for a particular capital-market participant to seek a separate ruling or order from the Commission on an ad-hoc basis. Blanket rulings and orders eliminate costs, delays and uncertainty caused by individual applications for discretionary relief. The ability to issue blanket rulings and orders in connection with non-contentious recurring situations provides the regulator with another useful tool to address changes in the marketplace in a timely manner.

The Daniels Committee recognized the importance of blanket rulings and orders to a modern system of securities regulation. In its interim report, the Daniels Committee noted:

> If properly utilized, the blanket ruling constitutes an effective means for incremental policy-making by the Commission. Specifically, the blanket ruling permits the Commission to exercise its discretionary exemption powers in respect of a class of cases involving similar or identical facts with which the Commission has had considerable regulatory experience. Blanket rulings permit

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[137] See comment letter of Ogilvy Renault.

[138] Orders are granted pursuant to the Commission's exempting powers in sections 83, 144 and 147 of the Act. Rulings are granted pursuant to the Commission's exempting power in subsection 74(1) of the Act.

[139] Prior to the 1994 Amendments, the Commission had the ability under various statutory exemption powers to issue blanket rulings and orders. For example, the Commission had the power under subsection 121(2) of the Act to exempt any class of persons or companies or class of transactions from the requirements of Part 21 of the Act.

> the parties to avoid the costs and uncertainty of regulatory hearings in respect of matters where the Commission's thinking has crystallized.[140]

In its final report, the Daniels Committee ultimately decided, however, that if the Commission were to receive rulemaking power, there would be little need for the Commission to continue its use of blanket rulings and orders. It recommended including exempting rules, which would be subject to notice and comment requirements, within the Commission's general rulemaking power:[141]

> Replacing the blanket ruling instrument with exempting rules would have the benefit of simplifying the regime through the reduction of the number of regulatory instruments used. Most significantly, however, the resulting exempting rules would be subject to the notice and comment requirements and the cabinet disapproval period that we recommend for rules generally – requirements that the Commission is not statutorily bound to adhere to presently. On a going forward basis, we regard these procedural protections as appropriate and necessary given the rule like character of the blanket rulings and orders.[142]

The Government of Ontario accepted the recommendation of the Daniels Committee and eliminated the Commission's authority to issue blanket rulings and orders as part of the 1994 Amendments.[143] We received many comment letters, however, that support reinstating the Commission's power to issue blanket rulings and orders to respond in a timely manner to emerging issues of general concern.[144]

We believe that blanket rulings and orders complement rather than undermine the rulemaking process. The weekly Bulletins abound with examples of applications for relief routinely given by the Commission. It would be much more efficient for the Commission to issue a blanket ruling or order when it becomes apparent that there is a general need for exemptive relief. For example, instead of issuing identical rulings and orders to individual applicants on a weekly basis, the Commission could have issued blanket rulings and orders to:

- permit mutual funds to track stock market indices without violating concentration limits;
- grant registration and prospectus relief with respect to exchangeable shares transactions; and

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[140] The Daniels Report, *supra* note 11 at page 22.

[141] For example, paragraphs 8 and 20 of subsection 143(1) of the Act give the Commission authority to make rules for exemptions from the registration and prospectus requirements under the Act or for the removal of exemptions from those requirements.

[142] The Daniels Report, *supra* note 11 at page 3223.

[143] The Commission is now prohibited under section 143.11 of the Act from making any orders or rulings of general application.

[144] See comment letters of the Certified General Accountants of Ontario, the Investment Counsel Association of Canada, the Royal Bank of Canada, the Ontario Teachers' Pension Plan, the Canadian Bankers Association, the Nova Scotia Securities Commission, and the Securities Subcommittee of the Ontario Bar Association. See also the comment letters on the Issues List of the BCSC and Torys LLP.

- permit related underwriters to act as underwriters in connection with a distribution of securities of a connected issuer subject to appropriate conditions.

While we believe that the Commission should have the ability to issue blanket rulings and orders, we are sensitive to concerns relating to proliferation of regulatory instruments and Ministerial accountability. Therefore, in our Draft Report we recommended that any blanket ruling or order be subject to a sunset clause of three years from the date of the introduction of the blanket ruling or order. This would provide the Commission with sufficient time to prepare a draft rule on the topic of the blanket ruling or order, issue it for public comment and submit it for Ministerial approval.

Two commenters on this recommendation believed, however, that a sunset period was unnecessary.[145] They argued that the proposed sunset provision would add inefficiencies into the system and that our concerns were not warranted given that the scope of the blanket rulings being proposed by the Committee were restricted so that they could only provide exemptive relief. We are also concerned that the inclusion of a sunset clause could potentially place market participants relying on the exemptive relief in jeopardy if the Commission was unable to get a rule in place in time. We also note that other Canadian securities regulators with blanket ruling authority are not subject to a sunset clause. The desirability of harmonization in this regard weighed against inclusion of a sunset clause in the Act. We have therefore deleted the requirement for a sunset period from our recommendation.

We also rejected the suggestion that blanket rulings should be subject to a 30-day public notice and comment period.[146] While we agree that the Commission should, where practicable and appropriate, seek public input on a proposed blanket ruling, we do not believe that notice and comment should be legislatively mandated for blanket rulings. We are concerned that a mandatory notice and comment period may not be feasible because exemptive relief applications are often time sensitive.

Recommendation:

We recommend that the Act be amended to allow the Commission to issue blanket rulings and orders that provide exemptive relief only.

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[145] See comment letters of the Canadian Bankers Association and the Nova Scotia Securities Commission.

[146] See comment letter of the Ontario Teachers' Pension Plan.

7.6 Publication of Exemption Requests Granted or Denied under Rules

Currently, when the Commission grants an exemption pursuant to the Act, the order granting the exemption is published in the Bulletin, allowing others to understand the reasons for the granting of the exemption. The Commission has not yet consistently adopted this approach with respect to exemptions granted from securities rules.[147] We believe that market participants would benefit from such transparency. We therefore recommend that the Commission publish exemption orders granted from the requirements of securities rules. We also recommend that the Commission provide notice when applications for exemptive relief are not granted, and of the reason for the refusal, subject to keeping the name of the applicant confidential.[148]

Recommendation:

We recommend that the Commission publish exemption orders granted from the requirements of securities rules. We also recommend that the Commission provide notice when applications for exemptive relief are not granted, and of the reason for the refusal, subject to keeping the name of the applicant confidential.

7.7 Review of Ontario Securities Law

The Act requires that the Minister of Finance establish an advisory committee every five years to review the legislation, regulations and rules relating to matters dealt with by the Commission and the legislative needs of the Commission.[149] We are the first such committee to be established. The Committee considered the provision in the Act which requires the Minister to appoint a committee every five years. As discussed in the Introduction, the Minister will be required to appoint the next committee at the end of 2004. That may follow too soon upon the submission of this Report. Thus, we believe that future review committees should be appointed five years after the date of delivery of the final report of the previous committee in contrast to the existing provision.

We received comments relating to the composition of such committees.[150] For instance, the Canadian Investor Relations Institute recommends that the Minister consider selecting representatives from both an interlisted (Canadian/U.S.) issuer and a TSX-only issuer to ensure that "vital compliance topics are addressed from a first-hand perspective."[151] We believe that committee membership should represent a diversity of backgrounds and interests relevant to the capital markets but we note that not every representative stakeholder must be on the Committee in order to have its views considered. Rather, it is important for all stakeholders to have an opportunity to raise issues of particular concern to them through whatever process the Committee decides to adopt.

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[147] By way of example, the Commission does publish exemption orders granted under OSC Rule 61-501 *Insider Bids, Issuer Bids, Going Private Transactions and Related Party Transactions*.

[148] Three commenters agreed that notice should be provided to the marketplace when exemptive relief applications are not granted but recommended that the identity of the applicant should be kept confidential. We agreed with this comment and revised our recommendation from the Draft Report accordingly.

[149] The Act, section 142.12.

[150] See comment letter of the Canadian Investor Relations Institute.

We also received comments which proposed implementation of time limits on the delivery of the Draft and Final Reports.[152] The Committee considered these comments and concluded that in order for the Committee to function on a shorter time frame, it would need to have a budget allocation from the Minister of Finance to hire a full-time staff. In addition, we note that the Minister and future committees have the ability to shorten the time frame required to complete future reports by casting the mandate of the Committee more narrowly.

Recommendation:

We recommend that the Act be amended to require that future review committees be appointed five years after the date of delivery of the final report of the previous committee. We recommend that Committee membership represent a diversity of backgrounds and interests relevant to the capital markets.

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[151] *Ibid.*

[152] See comment letters of Ontario Teachers' Pension Plan, Robert Kyle, and the TSX.

THE IMPACT OF THE INTERNET

8.1 Overview

The Internet has created a new environment for companies, dealers, advisers and other intermediaries as well as for investors. Websites, bulletin boards, e-mail and push technology permit real-time, widespread and low-cost communication. Research indicates that the Internet is not just an information channel: it has blurred the lines between information on the one hand, and advice, sales and promotion on the other hand.[153]

As a communication vehicle the Internet impacts a number of issues such as registration, enforcement and proxy solicitation. Reporting issuers are using the Internet to conduct public offerings, communicate with shareholders and potential investors, and conduct shareholder meetings. Intermediaries are using the Internet for marketing purposes, and for communicating with, and receiving orders from, potential investors. Retail investors are using the Internet to open and maintain accounts online, to trade without the assistance of a registered intermediary,[154] to communicate with other investors and as a research and investment tool.[155] The Internet is also providing retail investors with direct access to an unprecedented amount of information, previously available only to institutions and "sophisticated" investors.

In this chapter, the Committee considered whether amendments to the Act are necessary as a result of the use of the Internet by capital-market participants. The issues we considered in this context include:

- the conduct of offerings over the Internet;
- satisfying delivery obligations by the Internet; and
- substituting postings on the Internet as a proxy for satisfying delivery obligations.

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[153] Bank Works Trading Inc., *Making Money on the Web 2001: The Web and Other Channel Preferences* (March 2001) (www.bankworks.com).

[154] Eighty-seven per cent of affluent online investors (i.e., average $100K-125K household income and $100K-160K of investable assets) use an adviser to some degree. Thirty-three per cent of affluent investors, whose primary investment provider is a discount broker, say they receive no financial advice. (*Ibid.*)

[155] Fifty-nine per cent of Canadians have direct in-home or office Internet access, but a far smaller percentage is doing meaningful activity (Ipsos-Reid, Canadian Telecom & IT Review, Third Quarter, 2000 (http://reailinteractive.ca)). Research and tracking are the dominant activity among affluent investors, with 95 per cent using the Internet for research. (*Ibid.*)

In Chapter 9 we also consider the impact of the Internet on registration issues, including the emergence and regulation of financial portals and the obligation to conduct suitability determinations with respect to investors who trade securities over the Internet.

Finally, the Internet has also created new avenues for fraud. This is because the Internet offers a medium that is fast, cheap, easy to use and relatively anonymous. In Part 6, we make a number of recommendations aimed at strengthening the Act's enforcement regime, which should also assist in enhancing the Commission's efforts to deal with on-line securities fraud.

8.2 Application of Existing Regulation to Internet Communications

The CSA has twice issued interpretative policy guidance identifying issues to consider when using Internet communications in the context of activities regulated by the Act. These policies, National Policy 47-201 *Trading in Securities Using the Internet and Other Electronic Means* and National Policy 11-201 *Delivery of Documents by Electronic Means*, do not make any changes to the Act.[156] Market participants must still adhere to the requirements in the Act and subordinate legislation even if they are communicating electronically with each other. These policies set out guidelines but allow "participants to determine how they wish to comply with corporate and securities law requirements."

We encourage the Commission to monitor the need for further guidance with respect to Internet communications and update the relevant policy statements as necessary. For example, guidance could be issued discussing instances in which hyperlinked documents will be considered by the CSA to form a part of a company's disclosure record and the types of website disclosure that may attract civil liability.

8.3 Electronic Commerce Act

Less than a year after the CSA adopted National Policies 11-201 and 47-201, the Province of Ontario passed the *Electronic Commerce Act, 2000* (the "ECA"). Similar legislation has either been tabled or passed in other provinces.

The objective of the ECA was to "cut red tape and remove outdated legal barriers to e-commerce" in order to bring Ontario laws in line with technological advances.[157] The ECA ensures that electronic contracts, documents and signatures have the same legal effect as contracts, documents and signatures on paper; sets rules for automated transactions; adopts national and international standards for e-commerce law; and requires consent for the provision of information in electronic form.

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[156] (1999), 22 OSCB 8173 and (1999), 22 OSCB 8163.

[157] S.O. 2000, c. 17. See Government of Ontario Press Release issued October 16, 2001, announcing the passage of the ECA.

There is potential for inconsistencies and even conflict between the two CSA National Policies and the ECA. For example, a potential conflict could arise for an issuer if it were trying to determine whether it could deliver financial statements to shareholders, who had provided their consent, by posting these statements on the issuer's website. National Policy 11-201 suggests that delivery obligations can generally be satisfied by posting the relevant documents on a website if the investor has consented. In contrast, the ECA sets out circumstances in which merely making electronic information or documents available for access at a website will not constitute effective delivery. While our purpose is not to undertake an exhaustive review and comparison of the provisions of National Policy 11-201 and the ECA, we note that there are other provisions of the ECA that raise issues as to its impact on the guidance afforded by National Policy 11-201.

We believe the guidance offered by these National Policies has been helpful to many participants in the capital markets and that it is important that market participants be able to continue to rely on these policies. To the extent there is any inconsistency between the ECA and the National Policies, or perceived inconsistency, the CSA should amend the Policies, reformulate them as rules if necessary, or issue a notice providing guidance on how the ECA and the National Policies interact.

Recommendation:

We recommend that the CSA consider whether NP 11-201 *Electronic Delivery of Documents* and NP 47-201 *Trading Securities Using the Internet and Other Electronic Means* conflict with provincial legislation such as the ECA. We believe that the CSA should ensure that its guidance continues to be relevant and should issue a commuiqué to market participants setting out its views.

8.4 Internet Offerings

There have been some examples in the U.S., and to a much lesser extent in Canada, of issuers raising capital by offering securities on the Internet. Internet offerings conducted without the involvement of an underwriter are referred to as direct public offerings (DPOs). In 1998, e-minerals exploration corp., a Canadian junior mining company, completed the first DPO in Canada. Investors were permitted to subscribe for the offered shares by completing the on-line subscription agreement available at the website and submitting it electronically via the Internet. Since that time there have been no pure DPOs, although some companies have offered their securities over the Internet in conjunction with conventional sales by underwriters (e.g., flowthru.com, 1999). In addition, in the U.S., offerings of debt securities over the Internet by various governmental bodies are gaining increasing success and popularity.

Commenters on the Issues List noted that, except for National Policies 11-201 and 47-201, neither the CSA nor the Commission has offered guidance with respect to how securities can be offered over the Internet under existing Canadian securities laws. However, they did not provide specific examples of areas in which guidance is required. Market actors should start from the premise that the Act in no way prohibits Internet offerings and that the requirements that apply to paper-based offerings continue to apply to on-line offerings. The CSA has provided some guidance in NP 47-201 but has made it clear that this policy guidance does not change any substantive requirements of securities legislation.[158] Accordingly, the Committee is of the view that additional regulation governing the sale or offering of securities on the Internet is unnecessary.

Pure DPOs are conducted without the involvement of a registered dealer. However, the Act requires that all trades in securities (including a primary distribution by an issuer) must be made through a registered dealer.[159] Therefore, DPO issuers must find another way to comply with the requirement for trades in securities to be made through a registered dealer. The DPOs that have been completed to date have been done by having the issuer itself register as a dealer in the category of "security issuer" (defined as "an issuer that is registered for trading in securities for the purpose of distributing securities of its own issue solely for its own account").

Some argue that requiring an issuer to register as a dealer under the security issuer category is cumbersome and impedes an issuer's ability to quickly complete an offering of securities on the Internet. These commenters believe that eliminating the security issuer requirement would be desirable from the standpoint of the issuer because it enables the issuer to go to market more quickly.

However, eliminating the security issuer registration requirement would leave important investor protection issues unaddressed.[160] The Committee does not believe there is anything about an Internet offering that eliminates the public policy rationale for the registration requirement. Without the appropriate know-your-client and suitability checks in place, investors may purchase securities that are highly speculative and inappropriate for the investor given his or her personal circumstances, investment experience, investment objectives and financial means.

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[158] See "Responses to Comments" in National Policy 47-201 (1999), 22 OSCB or online at: osc.gov.on.ca/en/Regulation/Rulemaking/Policies/47-201_19991217.html.

[159] The Act, section 25.

[160] See comment letter of the IDA.

In the Committee's view, if suitability and know-your-client assessments are necessary and appropriate protections in the context of offerings which are not conducted over the Internet, we see no reason why they should be unnecessary in the context of Internet offerings.[161]

Recommendation:

In light of investor protection concerns, we believe that it would not be prudent to eliminate the need for dealer registrant involvement in Internet offerings.

8.5 Methods of Delivery

When an issuer is required to deliver documents to its shareholders, the Act does not specify the method of delivery except in a take-over bid context where delivery "by pre-paid mail" is contemplated. The CSA has offered guidance through National Policy 11-201 for issuers who wish to deliver these documents electronically. If an issuer satisfies four criteria set out in the Policy, then an issuer may deliver documents electronically unless some other method of delivery is specifically required by the Act.[162] The Committee agrees with this approach, as it offers flexibility to issuers who wish to avail themselves of the benefits of electronic delivery, but only permits them to do so where the recipient actively chooses electronic delivery.

8.6 Access-Equals-Delivery

In May 2000, the SEC issued a Release in which it sought comment on whether the delivery model presently contained in U.S. securities legislation should be replaced with an "access-equals-delivery" model.[163] Under such a model, investors would be assumed to have access to the Internet, thereby allowing delivery to be accomplished solely by an issuer posting a document on the issuer's or a third party's website. In the Release, the SEC stated that:

> We believe that the time for an 'access-equals-delivery' model has not arrived yet. Internet access is more prevalent than in 1995, but many people in this country still do not enjoy the benefits of ready access to electronic media. Moreover, even investors who are online are unlikely to rely on the Internet as their sole means of obtaining information from issuers or intermediaries with

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[161] As we note in Chapter 9, not all trades in securities necessarily need to have a registrant do a suitability analysis, but all trades still need to be effected through registrants so that the know-your-client analysis, and its attendant protections, can be done.

[162] The four components of electronic delivery of documents are:

1. The recipient of the document receives notice that the document has been, or will be, sent electronically or otherwise electronically made available.
2. The recipient of the document has easy access to the document.
3. The deliverer of the document has evidence that the document has been delivered or otherwise made available to the recipient.
4. The document that is received by the recipient is not different from the document delivered or made available by the deliverer.

[163] "SEC Interpretation: Use of Electronic Media," Release Nos. 33-7856, 34-42728, IC-24426; File No. S7-11-00 (May, 2000).

> delivery obligations. Some investors decline electronic delivery because they do not wish to review a large document on their computer screens. Others decline electronic delivery because of the time that it takes to download and print a document.[164]

The comments received by the SEC at the time persuaded it not to abandon the present system of document delivery.

National Policy 11-201 states that "referring an intended recipient to a third party website will generally not constitute valid delivery unless the recipient had previously consented to this form of delivery."[165] Thus, the CSA would permit an issuer and shareholder to agree between themselves that delivery obligations can be satisfied by reference to the third-party website. However, the Policy does not, and could not, shift the onus of ensuring that shareholders receive disclosure documents from issuer to investor.

The delivery requirements in the Act must be re-evaluated in light of the Internet. The Commission, together with other members of the CSA, has responded to this imperative and we agree with the steps they have taken. The next step would be to consider whether "access-equals-delivery" is a viable model. Should investors bear the onus of retrieving materials from the issuer's website? What about investors who do not have access to the Internet, or electronic capabilities to download and print large documents containing advanced graphics? On the other hand, there is considerable anecdotal evidence that suggests many investors do not read or want all material required to be delivered to them. It is also clear that an access-equals-delivery approach would result in significant cost savings to the industry, which hopefully would be shared by investors.

In our Draft Report we suggested that as the approach to delivery evolves, one way for the CSA to phase in electronic delivery would be to consider whether different delivery obligations should apply to different categories of documents. For example, those documents that convey information but do not require any action by the shareholder (e.g., issuer's financial statements) might be considered appropriate candidates for an access-equals-delivery approach. On the other hand, documents that invite shareholders to take some form of specific action in connection with a particular corporate event (e.g., a take-over bid circular or a proxy circular) would require actual delivery.

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[164] *Ibid.*

[165] This statement appeared in the "Responses to Comments," which were attached to the final version of NP 11-201. The actual provision in the Policy is as follows: "An attempt to deliver documents by referring an intended recipient to a third party provider of the document, such as SEDAR, will not likely constitute valid delivery of the document, in the absence of consent given by the intended recipient to such method of delivery."

Subsequent to publication of our Draft Report in which we discussed the "access-equals-delivery" model, the CSA released for comment proposed National Instrument 51-102 *Continuous Disclosure Obligations*, which contemplates an access-equals-delivery model for certain continuous disclosure documents. Under the National Instrument, mandatory delivery of financial statements and MD&A to securityholders would be eliminated although these documents would continue to be posted to SEDAR. Issuers will only be obligated to deliver copies of these documents to securityholders that request them.[166]

Recommendation:

The CSA should monitor the success of the limited form of access-equals-delivery contemplated by proposed National Instrument 51-102 *Continuous Disclosure Obligations* with a view to determining whether the access-equals-delivery model can be expanded to encompass additional documents which securities legislation requires be delivered to investors.

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[166] In February 2003 the Joint Forum of Financial Market Regulators released for comment a discussion paper entitled *Rethinking Point of Sale Disclosure for Segregated Funds and Mutual Funds* (2003), 26 OSCB 1443. The discussion paper contemplates extending an access-equals-delivery approach to delivery of documents to mutual fund investors. The fund summary document, which would replace the current simplified prospectus, would need to be offered to consumers before a purchase is made. However, the base disclosure documents and continuous disclosure documents of a fund would be made available in electronic form, via a web-based posting, or in paper form if requested.

REGULATION OF MARKET PARTICIPANTS

In carrying out its mandate to protect investors and foster fair and efficient capital markets, the Commission regulates individuals and companies who give advice or trade in securities. The regulatory regime also makes use of SROs that exercise some direct oversight and responsibility for their respective areas of competence. SROs are in turn subject to oversight by the Commission. SROs can be a valuable complement to the Commission in achieving the objectives of regulation. In this part, we examine the role and regulation of key market participants including registrants, SROs and clearing agencies.

CHAPTER 9

REGISTRATION

9.1 Registration

The requirement for dealers and advisers to be registered is one of the fundamental concepts in securities regulation. Registration allows the Commission to impose proficiency and capital requirements on those who play these key roles in the capital markets and to impose and enforce certain standards of conduct. The Act provides that no person may "trade" in a security without being registered and that no person may act as an "adviser" without being registered.[167]

The Committee has focused on two issues in particular in reviewing the registration provisions in the Act. The first relates to the broad net cast by the requirement to be registered to effect a "trade" in a security. The second is the convergence between trading and advising activity. Businesses and individuals who have been registered to effect trades in securities as dealers and employees of dealers are providing more and more financial advice to their clients before executing a trade. However, the proficiency requirements for dealers and their employees are unchanged and are based on the dealer and its employees primarily providing trade execution services and not financial advice.

9.2 Should the Requirement to Be Registered to "Trade" in Securities Be Modified?

The definition of a "trade" is very broad.[168] It includes any act "in furtherance of a trade." The Act provides a number of exemptions from the registration requirement for trades where investor protection considerations do not require the involvement of a registrant.[169]

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[167] The Act, subsection 25.1(1).

[168] "Trade" or "trading" includes,

a) any sale or disposition of a security for valuable consideration, whether the terms of payment be on margin, instalment or otherwise, but does not include a purchase of a security or, except as provided in clause (d), a transfer, pledge or encumbrance of securities for the purpose of giving collateral for a debt made in good faith,
b) any participation as a trader in any transaction in a security through the facilities of any stock exchange or quotation and trade reporting system,
c) any receipt by a registrant of an order to buy or sell a security,
d) any transfer, pledge or encumbrancing of securities of an issuer from the holdings of any person or company or combination of persons or companies described in clause (c) of the definition of "distribution" for the purpose of giving collateral for a debt made in good faith, and
e) any act, advertisement, solicitation, conduct or negotiation directly or indirectly in furtherance of any of the foregoing. (The Act, subsection 1(1)).

[169] See, for example, the exemption provided at subparagraph 35(1)(12)(iii) of the Act, which is required in order to permit the exercise of conversion rights attached to convertible securities; the exemption provided at paragraph 35(1)(17) of the Act, which allows a holder to tender securities to a take-over bid; or the exemption provided at paragraph 35(1)(19) of the Act, which permits a company to issue stock options to its employees.

The Committee considered whether the registration requirement in the Act should be amended to require persons or companies who are "in the business of trading in securities," rather than persons who "trade" in a security,[170] to be registered. This would lessen the need for discretionary exemptions from the registration requirement for particular "trades," but investor protection concerns would continue to be addressed since registration would be required for those actively involved in the business of trading in securities.

There may be some concern that changing the registration requirement to "in the business of" trading would introduce uncertainty into the marketplace. There has been little, if any, administrative or judicial consideration of what "in the business of" means in the securities context. Given that registration to trade is a precondition to a person or company being able to trade in securities, there may be concerns about introducing a change in the fundamental test for registration to one which contains elements of subjectivity. The current test is clear: any trade in securities must be effected by a registrant unless there is an exemption.

On the other hand, there is considerable precedent for regulation only to the extent that activities are carried on by persons "in the business of" that activity. For example, the adviser requirement is not triggered each time a person gives advice on investing in, buying or selling a security. Instead, the person must be "engaging in, or holding himself, herself or itself out as engaging in, the business of advising others as to the investing in or buying or selling of securities." Consequently, there has been little reason for exemptions to the adviser registration requirement; the number of exemptions from the adviser registration requirement is, in fact, quite limited. Similarly, the definition of "market intermediary,"[171] which is the underpinning of the universal registration regime in Ontario, is based on the concept of being "in the business of" trading in securities. Thus, currently in Ontario both advisers and market intermediaries only need to register if they are "in the business."

The Committee considered the registration requirements in other jurisdictions of Canada. Most jurisdictions have a registration model for dealers similar to that in Ontario, whereby the trade registration requirement is based on trade activities rather than being in the business of trading. The Committee also considered, on a comparative basis, the registration requirements in the U.S., Australia, Hong Kong and the U.K. In the U.S., Australia and Hong Kong, the requirement to be registered as a dealer is triggered based on a person or organization being "in the business of" either effecting transactions or buying and selling securities (U.S.) or dealing in securities (Australia and Hong Kong). In addition, each of these jurisdictions has separate registration requirements for advisers.[172] Similarly, the requirements to be registered as an adviser in these jurisdictions require the person or organization to be engaged in the business of advisory activities as they are defined under the legislation. The U.K. has very recently moved to a registration requirement for anyone who is in the "investment business," which is defined as the business of being engaged in an activity listed on a Schedule to the act, and includes both trading activities and advising activities.

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[170] See comment letter on Issues List of Osler, Hoskin & Harcourt LLP.

[171] Section 204 of the Regulation.

[172] Recent amendments to Australian legislation, however, have moved to a model of one registration requirement regardless of whether the activity is dealing or advising.

We believe there is significant merit in moving to a requirement to be registered only for persons or companies which are "in the business of" trading in securities. Moving to a registration requirement based on being in the business of trading would simplify the Act by removing the need for it to contain numerous exemptions for particular types of "trades." It is a model that is already familiar because of the adviser and market intermediary registration requirements. It is a model that will be harmonized with the approach in other countries (the U.S., Australia, Hong Kong and the U.K.). The majority of comments we received on this recommendation were generally in favour of changing the trigger for registration to that of being in the business of trading in securities.[173]

Our primary consideration in reviewing whether the registration requirement for trading should be changed to an "in the business of" trigger is that there should be one consistent and intelligible scheme for registration across Canada. Business is frequently conducted in more than one province, and we would not advocate a model which further fragments the registration requirements across the country. We also seek to harmonize the registration requirements with other countries, if that is possible. At this point, a change in the registration requirement would be a marked departure from the scheme in the other Canadian jurisdictions. Therefore, although one commenter on the Draft Report strongly supported moving to this model regardless of whether it was adopted in the other Canadian jurisdictions,[174] we do not support adopting this model unless it is adopted across the country by the CSA. In matters of registration, national harmonization is ultimately more important than global harmonization.

Finally, in its comment letter on the Draft Report, the BCSC agreed with us that the system of registration would benefit from simplification but disagreed with our recommendation that the registration requirement relating to trading should be moved to a model requiring the person or company to be in the business of trading, feeling the benefits would not outweigh the risks. Instead, the BCSC proposes moving to a "firm-only" registration system. Only firms would need to register, and would keep regulators informed about individuals who represent the firm in trading or advising roles, and of changes in registration information.

We considered but ultimately decided not to endorse a firm-only registration model. While simplifying the registration process is critical, investor protection considerations are paramount when individuals deal with investors and their money. We prefer maintaining the connection between an individual registrant and the regulator which the current system provides. Registrants are reminded of their obligations to their investor clients when they are required to register directly with the regulator. Further, we believe consistent standards and requirements for individuals dealing with investors' money are crucial and will not be achieved if firms are allowed to set and oversee them. We believe that a simpler system of regulation can be achieved without regulators abdicating the oversight responsibility for setting and enforcing standards of fair dealing.

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[173] See comment letters of Investment Funds Institute of Canada, Ontario Teachers' Pension Plan, Davies Ward Phillips & Vineberg LLP and Torys LLP.

[174] See comment letter of Torys LLP.

Recommendation:

We recommend that the registration requirement relating to trading in securities should be moved to a model requiring the person or company to be "in the business" of trading. However, we would only support such a change if it were to be adopted across the country.

9.3 Does the Requirement to Be Registered to "Trade" in a Security Properly Capture the Range of Activities in Which Intermediaries Engage?

A) CHANGES IN TYPES OF SERVICES PROVIDED

The nature of the services intermediaries provide to their clients, particularly their retail clients, has evolved since the registration provisions in the Act were developed. The following are some of the most significant developments in recent years:

- *Dealers Providing Advice Beyond What Is "Incidental"* – The trading environment has changed significantly as a result of discount dealers who provide no investment advice and charge a much reduced per-transaction fee for trade execution services only. In an effort to distinguish themselves from discount dealers, full service dealers have developed delivery models and fee structures that focus on the advisory services they provide in contrast to the trade execution services provided by discount dealers. Historically, there has been no reason for registered dealers to register as advisers to carry out trade activities accompanied by incidental advisory services. In this business model, the advice they are providing falls within the exemption for adviser registration available when the provision of advice is "solely incidental to their principal business or occupation."[175] A dealer will generally rely on this exemption where it is compensated through trading commissions and is not compensated separately for providing advice. Today, however, dealers are offering more advice along with their trading services, and often are seeking to be compensated on a structured fee basis rather than on a trading commission basis. Arguably, this evolution raises issues about the continued availability of this exemption.

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[175] The Act, clause 34(c).

- *Financial Planners* – Financial planners are becoming increasingly prevalent in the Canadian marketplace. Financial planners frequently are licensed mutual funds salespersons dually licensed to sell life insurance. In addition to selling these products, they advise clients on other financial matters including mortgages, credit cards, retirement planning and estate planning. As the range of matters on which they advise exceeds the ambit of the Act, securities regulators have been struggling to find an effective model for regulating financial planners.
- *Internet* – The Internet also raises issues for registration regimes. Numerous websites offer advice and recommendations concerning securities. To the extent no fees are paid for this advice, it is arguable that persons operating the websites are not "in the business of" advising others and therefore are not caught by the current definition of "adviser."

B) INCIDENTAL ADVISORY ACTIVITIES

As a consequence of these changes in market practice and the increased blending of trading and advising activities in some services offered by dealers (i.e., "wrap accounts"), the Committee considered whether the requirement to be registered to trade in securities should be refocused to address advisory functions as well as trade execution services.

As a preliminary matter, we note that any expansion we recommend of the registration requirements applicable to those trading in securities to encompass their expanded advisory activities is not intended to replace the current adviser registration requirements. Advisers registered as investment counsellors and portfolio managers under the Act are subject to some of the most stringent registration requirements of the Act. This is because registration as a portfolio manager permits a person to manage other people's money on a fully discretionary basis. The competency and experience of advisers must be commensurate with these responsibilities. We believe the current proficiency and experience requirements for advisers who are managing portfolio investments are appropriate and should be maintained.

Instead, we believe that the current registration requirements applicable to dealers should be examined carefully by the Commission and the CSA with a view to ensuring that the applicable regulatory requirements match the expanded role that has developed for "incidental advising."[176] We do not believe that dealers and their employees should be restricted from expanding the services offered to their clients, but the proficiency, experience, suitability and other regulatory requirements which currently apply to brokers must be flexible enough to adapt to these marketplace shifts.

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[176] In its comment letter the Canadian Association of Independent Financial Advisors suggests that the advisory activities its members participate in are not viewed by its members as incidental or ancillary, and regretted the use of these terms in the Draft Report. We use the term "incidental advice" as it is the term used in the Act.

C) THE COMMISSION'S "FAIR DEALING MODEL"

Since we issued the Draft Report, the Commission has launched an interactive website to introduce its proposed new model for regulating dealers and their salespersons, called the Fair Dealing Model.[177] The Fair Dealing Model proposes three different relationship models by which registrants will deal with their clients: (i) the "managed-for-you" relationship, which vests primary investment decision-making responsibility in the registrant; (ii) the "advisory relationship" whereby investment decision-making responsibility is shared between the registrant and the client; and (iii) the "self-managed relationship" in which primary responsibility for investment decision-making rests with the client. Under each model the interactions between the registrant and client will vary depending upon where the decision-making concerning investments resides. While all details of the Fair Dealing Model are not yet available, it would appear likely that the levels of education and proficiency required of the registrant will vary depending upon the relationship model involved. If so, this would be consistent with our recommendation that the registration requirements be monitored to ensure they are sufficiently flexible to permit various models of trading/advising services to be delivered while at the same time being sufficiently rigorous to ensure the proper requirements for those who are increasingly delivering advice but relying on the "incidental advice" exemption to do so.

Recommendation:

We believe that the Act should continue to distinguish between the requirement to be registered to advise concerning securities and the requirement to be registered to trade in securities (or, as we propose in our earlier recommendation, to be in the business of trading in securities). However, we recommend that the Commission and CSA carefully review the proficiency, experience and suitability requirements applicable to dealers and employees to ensure that they are sufficiently flexible to permit various models for delivering advice while at the same time ensuring that they are sufficiently rigorous to match the increasingly important role of "incidental advice" provided by dealers and salespersons.

D) TRADE EXECUTION ONLY SERVICES

Some dealers (or business units) have moved to eliminate all ancillary advisory services and to offer trade execution services only. We examined whether there are activities or transactions that should be exempt from the need to involve a regulated entity. We also considered whether the traditional obligations of registrants, such as assessments of suitability and "know-your-client" obligations, need to be examined in an electronic trading environment.

In April 2000, the CSA announced that relief from the suitability obligations will be granted on an application basis to dealers who offer only trade execution services to their clients.[178]

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[177] See www.fairdealingmodel.com.

[178] CSA news release, "CSA Provides Relief from Suitability Obligations" (April 10, 2000), 23 OSCB 2683.

Subsequently the IDA amended its regulation to provide that all IDA member dealers do not have to conduct suitability analyses in cases where the client is not provided with a recommendation on a particular transaction.[179]

Early commenters to the Committee on this topic indicated that, if investors feel capable of making an investment decision and knowingly choose to make their decision without any recommendation, advice or suitability analysis from a registrant, there are no investor protection issues that require regulators to prohibit investors from trading without the benefit of all the services provided by a registrant. Such investors will have waived their right to one important basis of recourse in the event of a dispute concerning a trade, because most such disputes centre on the suitability of the trade. It is critical that investors understand they are waiving this one potential remedy when they waive the suitability protections.

We agree that investors who wish to avail themselves of reduced trading fees should be allowed to trade with dealers who are relieved of the requirement to conduct suitability analyses. However, the "know-your-client" requirements of securities legislation are at least as important today as they ever were.[180] We believe that dealers should always have to know: (i) who their client is – including the ultimate beneficial owner; (ii) that their client has the financial wherewithal to complete the transaction; and (iii) the source of the client's funds. Dealers should be able to transact with clients without determining whether a trade is suitable in certain situations; however, dealers must always know the clients with whom they are conducting business.

E) FINANCIAL PLANNING ACTIVITIES

With respect to the advising activities undertaken by financial planners, the Committee understands the concerns of the Commission and the CSA that persons who are registered in a restricted category of dealer are adopting titles which appear to convey a degree of experience and expertise which may be misleading to the public. We note that the CSA has published MI 33-107 *Proficiency Requirements for Registrants Holding Themselves Out as Providing Financial Planning and Similar Advice*.[181] The Instrument would impose proficiency requirements on any registrant adopting a title that conveys that "financial planning or similar objective, comprehensive, integrated personal financial advice is offered."[182] In Ontario, the Minister returned the Instrument to the Commission for further consideration, and it has not come into force in any jurisdiction in Canada. While the Instrument has not been without controversy, we support what the CSA is trying to achieve through this initiative and the proposition that registrants who wish to be in business to trade in securities and offer ancillary advice in connection with that business must be proficient and qualified to do so.

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[179] (2001), 24 OSCB 2923 and 4513.

[180] See the comment letter of the Nova Scotia Securities Commission.

[181] (2001), 24 OSCB 1107.

[182] *Ibid.*

F) FINANCIAL PORTALS

Financial portals, chatrooms and similar discussion forums available through the Internet provide financial and market information and advice concerning investment in securities. The content on these websites typically includes information such as news on industry sectors and trends, company and fund research, earnings estimates, price and news alerts, research reports and lists of stocks that portfolio managers are purchasing. Many of these websites contain on-line discussion forums relating to particular stocks and industries. Some provide model portfolios with specific stock recommendations.

The Committee believes that portals and similar multi-user mechanisms may be engaging in registrable activities depending upon the nature of the portal, the information provided, the role played by the portal "sponsor" and other fact-specific considerations. The Commission, as the principal regulator under the MRRS, considered these issues in the CanIssue decision.[183] This application dealt with a company which was established as a vehicle through which certain dealers would make information regarding corporate debt issues available to institutional investors on a website. The company, owned by the dealers, would not make profits or distributions to shareholders. The company was being used as a mechanism to allow the dealers to share the expense of operating the website. In its decision, the Commission provided an exemption from registration to the company under specific conditions, including the requirement that the dealers participating in the system would be registered as dealers in their respective jurisdictions. We endorse the flexibility inherent in this approach and encourage the Commission to continue to facilitate the use of financial portals when appropriate.

At the same time we encourage the Commission, together with the CSA, to continue to monitor the use of financial portals and other sites by market participants. Enforcement proceedings are an appropriate regulatory tool to address inappropriate conduct by persons involved in these Internet activities.[184] Our recommendation in Chapter 24 to expand the Act's enforcement mechanisms by creating an offence of fraud and market manipulation will enhance the Commission's ability to regulate these activities by enforcement rather than by imposing a new registration requirement.

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[183] *In the Matter of CanIssue Inc.* (2001), 24 OSCB 4533.

[184] On February 26, 2002, the Commission issued temporary cease-trade orders against Create-a-fund Incorporated, alleging it offers websites which purport to offer investment services such as portfolio customizing and investment monitoring for which registration is required.

Recommendation:

We encourage the Commission, together with the CSA, to continue to monitor the use of financial portals by market participants, and to facilitate their development where appropriate. Where portals conduct activity in violation of the requirements of the Act, regulators can address this conduct through enforcement proceedings where appropriate.

9.4 How Can the Registration System Be Made More Efficient?

The current registration system in Canada suffers from a number of impediments to efficiency. The first is the lack of harmonization of the substantive requirements relating to registration. The second impediment to efficiency is the current cumbersome paper-intensive process for filing registration materials with multiple regulators across the country. A person or company which wishes to be registered to do business in more than one jurisdiction must determine the relevant rules in each separate province and then complete multiple paper applications and supporting documents which are filed separately with the regulator in each applicable jurisdiction. The CSA are proposing to introduce a National Registration Database[185] in the spring of 2003. The purpose of the NRD is to require that certain registration information which must be provided to the securities regulatory authorities be submitted to them electronically through the NRD and registration fees will also be payable through the NRD. While the proposed introduction of the NRD will assist in making the registration process more efficient, it will only simplify the procedural aspects of registration. As long as registrants and their advisors need to continue to comply with varying substantive registration requirements in the different provinces, the efficiencies that the NRD promises cannot be fully realized. Registration requirements must be harmonized across the country.

We received a comment letter which suggested that the investing public will benefit from full, true and plain disclosure as to an individual's background and experience at the time an investor opens an account with that individual, including length of experience in the industry, with the current dealer employer and with previous employers; any prior disciplinary proceedings against the individual; and the types of products the individual is licensed to sell.[186] We agree, and recommend that modifications be made to the NRD following its launch to permit investors to access this type of information about registrants.[187]

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[185] MI 31-102 *National Registration Database* (2002), 25 OSCB 7509.

[186] See comment letter of the Small Investor Protection Association.

[187] The Committee received a comment from the Canadian Association of Independent Financial Advisors requesting that we consider dispensing with language in our Final Report which contemplates that dealers and salespersons are in an employer-employee relationship. We are aware that the Canadian Association of Independent Financial Advisors is urging regulators to reconsider the current regulatory structure which contemplates salespersons to be in an employment relationship with dealers. However, where describing the existing regulatory provisions under the Act, this language is appropriately used.

Recommendation:

We recommend that securities legislation in the provinces be amended to provide consistent substantive registration requirements across the country. We further recommend that the NRD be modified following its launch to permit investors to access relevant information about registrants, including industry experience, any previous disciplinary proceedings to which the registrant was subject, and the products which the registrant is licensed to sell.

9.5 Universal Registration

The Committee considered whether the concept of universal registration should be eliminated. As noted above, the Act requires any person or company trading in a security to be registered as a dealer, and anyone in the business of advising to be registered as an adviser. The Act also contains exemptions from these registration requirements. In all provinces, and in Ontario and Newfoundland prior to 1987, prospectus and dealer registration exemptions of applicable securities legislation tend to operate in tandem; that is, if there is an exemption from the requirement to prepare a prospectus, there is also an exemption from the requirement to effect the trade in the security through a registrant. The premise underlying these exemptions is that there are certain types of securities, trades and purchasers for which and for whom the protections of the Act, as embodied in the prospectus and registration requirements, are not necessary.

In 1987, however, Ontario introduced a system of universal registration, which was subsequently adopted by Newfoundland but has not been adopted by any other Canadian jurisdiction. With the introduction of universal registration, "market intermediaries" (as defined) became unable to trade in securities in reliance on the exemptions in the Act.[188] The result of the introduction of universal registration was, in effect, to impose an obligation to be registered in some category on every trading participant in the Ontario markets that fell within the definition of "market intermediary." As noted above in section 9.2, the philosophy underlying the universal registration requirements is consistent with a "being in the business" trigger.

Dealers which, prior to the adoption of the universal registration regime, were not required to be registered to deal in exempt securities now must be registered. We note that most are registered in the category of limited market dealer. The category is often criticized because it contains no capital adequacy or reporting requirements; registration is generally granted on the basis of an application and payment of the requisite fee. The universal registration regime is cumbersome and unique to Ontario and Newfoundland.

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[188] A "market intermediary" is defined in section 204 of the Regulation as: a person or company that engages or holds himself, herself or itself out as engaging in Ontario in the business of trading in securities as principal or agent, other than trading in securities purchased by the person or company for his, her or its own account for investment only and not with a view to resale or distribution, and, without limiting the generality of the foregoing, includes a person or company that engages or holds himself, herself or itself out as engaging in the business of,

a) entering into agreements or arrangements with underwriters or issuers, in connection with distributions of securities, to purchase or sell such securities,
b) participating in distributions of securities as a selling group member,
c) making a market in securities, or
d) trading in securities with accounts fully managed by the person or company as agent or trustee, whether or not the person or company engages in trading in securities purchased for investment only.

Commenters to the Committee on the original Issues List had divergent views as to whether the system of universal registration should be eliminated.[189] The arguments in favour of abolishing universal registration are that it inhibits regulatory harmonization and that it is complicated. The arguments in favour of maintaining universal registration are based on the need for a level playing field and upon the presumption that investor protection is augmented and solvency risk reduced by regulating participants in the market. However, the limited market dealer category currently appears to be relatively ineffective in achieving these goals. Every commenter on this recommendation in the Draft Report supported the recommendation to eliminate this requirement.

If the registration model is amended as we propose to a "being in the business" trigger as opposed to a trade-triggered approach, then we would accomplish directly what universal registration was intended to accomplish indirectly. The need for universal registration would, therefore, be obviated. Even if the registration model is not amended as we propose, we believe that the universal registration requirements should be eliminated from the Act because, in view of the way they have been implemented, they do not bring any real investor protection or address any matters of systemic risk. Further, they are out of step with regulation in the rest of the country.

Recommendation:

We recommend the Act be amended to eliminate the universal registration requirements.

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[189] See comment letters on the Issues List of the Canadian Bankers Association, the Investment Counsel Association of Canada, Financial Services Commission of Ontario, Simon Romano, Nancy Ross, and the IDA.

SELF-REGULATION

10.1 Overview

Part VIII of the Act is entitled "Self-Regulation." Self-regulation allows an industry organization (rather than the Commission) to supervise the conduct of certain market participants, subject to general oversight by the Commission. Part VIII deals with certain organizations which play a role in the self-regulation of Ontario's markets, including SROs, stock exchanges,[190] clearing agencies[191] and QTRSs.[192]

Currently, stock exchanges are the only organizations engaged in the self-regulatory process in Ontario which must be recognized by the Commission in order to carry on their activities in Ontario; the other organizations may choose to be recognized but do not have to be recognized to carry on their activities. When an organization is "recognized" by the Commission, it becomes subject to oversight by the Commission to the extent that it regulates the operations and standards of practice and business conduct of its members.[193] The Commission has the authority to review any of the organization's directions, decisions, orders or rulings.[194] In addition, when an entity is "recognized" by the Commission, it becomes a "market participant." Among other things, this makes the entity subject to provisions of the Act other than Part VIII such as financial examination orders (section 12), the power of an investigation examiner (section 13), compliance reviews (section 20), public interest orders (section 127) and applications to court (section 128).

In this chapter we consider whether any of the organizations regulated by Part VIII, other than stock exchanges, should have to be recognized by the Commission. We also consider other important issues relating to self-regulation.

10.2 Should SROs Be Required to Be Recognized?

An SRO is "a person or company that represents registrants and is organized for the purpose of regulating the operations and the standards of practice and business conduct of its members and their representatives with a view to promoting the protection of investors and the public interest."[195] SROs may apply for recognition, but they are not obliged to be recognized. Some SROs are voluntary in the sense that their members are not required to join as a condition of registration under the Act. Only the IDA, the MFDA and RS Inc.[196] have been recognized by the Commission as SROs. Every securities dealer, investment dealer, and broker is required to be a member of a recognized SRO (currently, the IDA).[197] Every mutual fund dealer is required to be a member of the MFDA.[198] Every ATS is required to retain a regulation services provider to set and enforce requirements governing the ATS and its subscribers (RS Inc).[199]

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[190] The Act, subsection 21(1). Subsection 1(1) of the Act defines "recognized stock exchange" as "a person or company recognized by the Commission under section 21."

[191] The Act, subsection 21.2(1). Subsection 1(1) of the Act defines "clearing agency" as "a person or company that acts as an intermediary in paying funds or delivering securities, or both, in connection with trades in securities and that provides centralized facilities for the clearing of trades in securities."

[192] The Act, subsection 21.2.1(1). Subsection 1(1) of the Act defines a QTRS as "a person or company that operates facilities that permit the dissemination of price quotations for the purchase and sale of securities and reports of completed transactions in securities for the exclusive use of registered dealers but does not include a stock exchange or a registered dealer."

[193] The Act, subsections 21(1), 21.2(1), 21.2.1(1), 21.1(1)(3).

[194] The Act, subsection 21.1(1)(4).

Under the Act, it is possible for an organization whose purpose is to regulate the operations and standards of practice of its members to establish itself as an SRO without being recognized. In fact, the IDA acted for decades as an SRO until it was formally recognized by the Commission in 1995. In our Draft Report we recommended that the Act should be amended to require that all SROs be recognized. We received strong opposition to this recommendation.[200] One commenter suggested that there should be a role for voluntary organizations which "do not desire to duplicate the activities of a regulatory authority or serve as an agent of the state."[201] Another stated that "any organization of registrants which seeks to establish standards for its members should not be discouraged."[202]

There is an important role for self-regulation in the securities industry. Self-regulation permits the Commission to assign certain regulatory responsibility for setting and enforcing standards of behaviour of registrants to an organization established by such registrants. Self-regulation permits individuals with the most knowledge about an industry to develop policies and rules for that industry. Enforcement of the rules is likely to be more effective as well, as the regulated entities are more likely to accept rules drawn up by the people with the most experience and expertise in the area.

However, there is always conflict inherent in self-regulation. An SRO may be more inclined to enact less stringent rules than would an arm's-length or government agency. There is also the possibility that an SRO could be less rigorous than an arm's-length party in enforcing compliance with such rules. Therefore, if the purpose of an SRO is to assume certain of the Commission's regulatory functions with respect to a group of registrants, it is imperative that the Commission is able to oversee the rules, procedures and processes of that SRO to ensure that the possible conflicts inherent in self-regulation are addressed.

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[195] The Act, subsection 1.1.

[196] RS Inc. was recognized by the Commission on January 29, 2002 ((2002), 25 OSCB 891). RS Inc. operates as a regulation services provider under the Alternative Trading System rules and administers and enforces trading rules for the marketplaces that retain its services.

[197] See OSC Rule 31-507 *SRO Membership – Securities Dealers and Brokers*, (2001), 23 OSCB 5657.

[198] See OSC Rule 31-506 *SRO Membership – Mutual Fund Dealers*, (2001), 24 OSCB 2333.

[199] See National Instrument 23-101 *Trading Rules*. An exchange or quotation and trade reporting system has the option of monitoring the conduct of its members or users and enforcing the requirements set either directly or indirectly through a regulation services provider.

[200] See comment letters of Association for Investment Management and Research, Canadian Association of Insurance and Financial Advisors and the Nova Scotia Securities Commission.

[201] See comment letter of the Canadian Association of Insurance and Financial Advisors.

[202] See comment letter of the Nova Scotia Securities Commission.

In light of the concerns we heard from commenters, we have reconsidered our original recommendation that every SRO in Ontario must be recognized. We believe flexibility in the legislation is important and we recognize that a legislative requirement that SROs be recognized will be appropriate in some situations, but not all. However, we also believe that those SROs that wish to assume certain of the Commission's regulatory functions with respect to a group of registrants must be recognized so as to give the Commission oversight capability. The legislation currently authorizes SROs to apply for recognition. We recommend that the legislation be amended to also expressly authorize the Commission to require SROs to apply for recognition where recognition would be in the public interest. By this we mean that where an SRO is taking on activities which are properly discharged by, or under the oversight of, the Commission, and that SRO does not apply for recognition before conducting such activities, the Commission should have the ability to require the SRO to become recognized so as to be subject to the Commission's oversight.

Recommendation:

We recommend that the Act be amended to authorize the Commission to require SROs to apply for recognition where an SRO is taking on activities which are properly discharged by, or subject to the oversight of, the Commission if the SRO has not otherwise applied to be recognized.

10.3 Should Recognition Be Required for Clearing Agencies?

A clearing agency is a "person or company that acts as an intermediary in paying funds or delivering securities, or both, in connection with trades in securities and that provides centralized facilities for the clearing of trades in securities." Clearing agencies may carry on business without being recognized by the Commission.[203] Currently, the Canadian Depository for Securities is recognized by the Commission as a clearing agency.

The Committee considered the important role that clearing agencies perform in securities transfers. Clearing agencies act as depositories, settle transactions on a delivery against payment basis, and assume settlement obligations. Prompt and accurate clearance and settlement of securities transactions is necessary to enhance the efficiency of the capital markets and to protect investors. In addition, inefficient procedures for clearance and settlement impose unnecessary costs on investors and create systemic risk.[204]

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[203] The Act, section 21.2.

[204] See the 1934 Act, subclauses 17A(b)(1), 17A(a)(1).

In light of the important role played by clearing agencies in establishing confidence in the capital markets,[205] the Committee believes that they should be required to obtain recognition. Requiring all agencies that carry on a clearing and settlement business in Ontario to be recognized subjects them to regulatory oversight and provides regulators with the necessary tools to impose minimum standards on those that perform this critical role. Finally, requiring clearing agencies to obtain recognition is in the public interest not only in terms of protecting investors and enhancing the efficiency of capital markets, but also in terms of safeguarding securities and maintaining fair competition.[206]

However, while we believe that clearing agencies should be required to be recognized by the Commission, we are not convinced that the current definition of "clearing agency" in the Act is precise enough or clearly captures the activities which a clearing agency engages in. The definition refers to intermediaries that pay funds or deliver securities in connection with securities trades and provides centralized facilities for the clearing of trades.[207] We recommend that the Commission reconsider this definition. We suggest looking for guidance to the definitions contained in U.S. legislation, which define a multilateral clearing organization as a "system utilized by more than two participants in which the bilateral credit exposures of market participants arising from the transactions cleared are effectively eliminated and replaced by a system of guarantees, insurance or mutualized risk of loss."[208] The U.S. definition appears to reflect more precisely that clearing agencies assume settlement obligations.

Recommendation:

We recommend that clearing agencies should be required to obtain recognition through an amendment to section 21.2 of the Act to provide that "No person or company shall carry on business as a clearing agency unless recognized by the Commission." We also recommend that the Commission re-examine the definition of "clearing agency" in section 1.1 of the Act to ensure that it properly captures the activities which should trigger the requirement to be recognized. In this regard, we suggest that consideration be given to the definition of "clearing agency" under U.S. legislation.

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[205] IOSCO, Report of the Technical Committee, *Objectives and Principles of Securities Regulation* (1998) (http://www.iosco.org/docs-public/1998objectivesdocument03.html).

[206] See the 1934 Act, subclause 17(A)(a)(2)(A).

[207] The Act, section 1.1.

[208] *Federal Deposit Insurance Corporation Improvement Act of 1991*, 105 Stat.2236, 12 U.S.C. § 188, section 408.

10.4 Should Recognition Be Required for QTRS?

The Committee also considered whether a person should be required to be recognized to carry on business as a QTRS.[209] A QTRS is defined in the Act as a "person or company that operates facilities that permit the dissemination of price quotations for the purchase and sale of securities and reports of completed transactions in securities for the exclusive use of registered dealers."

The definition of QTRS was developed when CDN was operating and was, we understand, intended to describe all of the activities in which CDN was engaged, including over-the-counter trading. As discussed more fully in section 10.5 below, CDN ceased operations as part of the reorganization of Canada's stock exchanges. In light of the changes to the market, we question whether the definition of QTRS continues to make sense and urge the Commission to re-examine this definition in a broader context.

We understand that the regulatory framework relating to QTRSs was developed at a time when technology did not facilitate dealer markets to execute orders electronically. However, because of significant technological advances, users of most QTRSs can electronically execute their orders. As a result, QTRSs and exchanges have become more functionally equivalent. We believe that it is important for QTRSs to maintain high standards in their operations and that the proper functioning of these entities is fundamental to investor confidence. We note that NI 21-101 *Marketplace Operation* (the "ATS Rule") contains many requirements for recognized QTRSs that are identical to the requirements applicable to exchanges, but, unlike exchanges, there is no specific requirement in the Act that a QTRS be recognized.

The Memorandum of Understanding on Exchanges and QTRSs also contemplates the establishment of an oversight program to ensure that each recognized exchange and QTRS meets appropriate standards for market operation and regulation.[210] We ask that the Commission consider whether QTRSs should be required to obtain recognition. We also urge the Commission to work with other Canadian jurisdictions to develop a harmonized approach to QTRSs.[211] In this regard, we note that several commenters on the Draft Report were in favour of requiring QTRSs to obtain recognition.[212] In particular, one commenter noted:

> We believe that mandatory recognition of QTRSs … is essential in developing a harmonized approach to protecting the public interest. Primarily, our concern relates to smaller, illiquid issuers typically traded on QTRSs…. Without a requirement to obtain recognition under

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[209] At present the Canadian Trading and Quotation System Inc. (CNQ) is the only recognized QTRS in Canada. CNQ was recognized by the Commission on February 28, 2003 and will operate an electronic marketplace for Ontario investment dealers to trade non-exchange listed securities of Ontario reporting issuers (www.osc.gov.on.ca/en/HotTopics).

[210] OSCB (13 September 2002) 6161 and OSCB (22 November 2002) 7761. On November 7, 2002, the Minister of Finance approved the MOU and it became effective on that date.

[211] We note that not all CSA jurisdictions define QTRSs or give their Commission express authority over QTRSs.

[212] See comment letters of the TSX and the TSX Venture Exchange.

> securities legislation and oversight by the Commission and/or CSA, we are concerned that investors may not have adequate protection against fraudulent and manipulative practices, which may impact detrimentally on all Canadian capital markets."[213]

Recommendation:

We recommend that the Commission and the CSA consider whether to require QTRSs to obtain recognition under securities legislation and to develop a harmonized approach to QTRSs, including re-examining the current definition of a QTRS in the Act.

10.5 Over-the-Counter Trading

As part of the reorganization of Canada's stock exchanges, CDN ceased operations on quoted and unquoted (reported) securities.[214] Companies that were "quoted" on CDN at the time were invited to list on the TSX Venture Exchange's Tier 3. Companies that were "reported" to CDN were not invited to list on the TSX Venture Exchange. Dealers that had been reporting trades in these securities to CDN were required to continue to report trades to the newly created CUB, a wholly owned subsidiary of the TSX Venture Exchange.

At the time CDN ceased operations, the Commission decided that reported over-the-counter transactions would be collected and maintained by CUB for its surveillance and the Commission's enforcement purposes only and would not be made public.[215] Prior to this decision, information concerning last trade price visibility had previously existed on CDN. In deciding to remove last trade price visibility, it appears that the Commission was persuaded that "the reporting of last sale price afforded investors limited transparency that may not have been related to the actual value of securities because of the extremely low volume of trading in these securities."[216] Also, the Commission was "concerned that such limited transparency gave investors a false comfort in the liquidity and value of the securities and created an opportunity for market manipulation."[217]

We received one comment letter on our Draft Report that specifically objected to the removal of last trade price visibility that had existed on CDN. The commenter noted:

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[213] See comment letter of the TSX.

[214] CDN issuers fell into two categories. First, the issuers in respect of which trading was merely reported on the CDN system in compliance with Ontario's mandatory over-the-counter trade reporting requirements contained in section 154 of the Regulations. Second, the issuers in respect of which, in addition to trade reporting, active and continuous bid and ask price quotations were posted on the CDN system.

[215] See section 5.1 of the OTC Agreement among CUB, TSX Venture Exchange and the Commission at (2000), 23 OSCB 8448.

[216] See Notice of Commission Approval – Canadian Venture Exchange Exemption from Recognition As A Stock Exchange Under Section 21 of the Act at (2000), 23 OSCB 8437.

[217] *Ibid.*

> Without the existence of [a] published market, it is impossible for an [unlisted and unquoted] issuer to raise funds through equity financings, including a prospectus financing or private placements, … grant employee stock options under favourable income tax treatment, as the options must be granted at market price or at a premium to the market, and enter into business combination agreements that are fair and reasonable to the shareholders of the issuer, with no value to be given to the market value of the issuer.[218]

We understand that the Commission has asked staff to monitor the transparency issue and to report back to it.[219] As noted in our Draft Report, we continue to believe that the over-the-counter market and, in particular CUB, merit regulatory review. We urge the Commission to complete its review of CUB as soon as possible, focusing particular attention on concerns relating to transparency and reducing CUB's exposure to abuse.

Recommendation:

We believe that CUB merits regulatory review and urge the Commission to complete its review of CUB as soon as possible, focusing particular attention on concerns relating to transparency and reducing CUB's exposure to abuse.

10.6 Enforcing Their Own Rules

In our Issues List, we asked whether recognized SROs and exchanges should have legislated enforcement powers with respect to their own rules. We asked this question because we are aware of a perception that it is sometimes difficult for these organizations to impose meaningful sanctions on their members, particularly if members resign from the SRO. Further, in the U.S. the 1934 Act explicitly permits an SRO to suspend or revoke a member's registration, to censure or impose limitations on the member, or to remove from office or censure any officer or director of a member if doing so would be in the public interest.[220]

In response, the IDA stated that: "SROs currently derive their authority from a contractual relationship with their members. We believe that this current relationship has worked satisfactorily and see no compelling reason to change it by legislating that relationship." TSX Venture Exchange stated that it would "encourage the adoption of legislation and rules which would improve the enforcement abilities of SROs, such as a subpoena power."

Recognized SROs and exchanges have the ability to establish codes of behaviour and practice, and establish sanctions for breach of these rules, both through contractual agreements with their members and through their by-laws. In our Draft Report we concluded that the Act does not need to be amended to provide SROs and exchanges with powers to do that which they can do contractually. We also noted, however, that there may be a need to give SROs statutory authority to conduct investigations and obtain evidence from non-members and specifically invited comment on this issue. We received several submissions on this point.

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[218] See comment letter of the Ontario Association of Unlisted Reporting Issuers.

[219] *Supra*, note 209.

[220] 1934 Act, section 19.

Ontario's SROs made a joint submission[221] that reiterated their earlier comments that in the majority of cases, contractual jurisdiction has been sufficient to fulfil their mandates. The Ontario SROs noted, however, that "as a result of undertaking more complex files, the increasing complexity of the capital markets, and instituting a risk-based approach to regulation, they require additional legislative support for [their] jurisdiction as well as [their] investigation and discipline process," including the enforcement of disciplinary orders. The Ontario SROs expressed concern that if they "cannot vindicate the public interest in their discipline process because jurisdiction is problematic, documents or witnesses are unavailable, or just and appropriate sanctions cannot be enforced," then the credibility of our regulatory regime will suffer, which may negatively impact investor confidence. In this regard, the Ontario SROs recommended that the Act be amended to give SROs the following statutory powers:

- jurisdiction over current and former members or "regulated persons" (as defined in the Universal Market Integrity Rules, other than a "marketplace") and their current and former directors, officers, partners and employees;
- the ability to compel witnesses to attend and produce documents at disciplinary hearings (currently Ontario SROs can compel documents and testimony only from registrants subject to agreements);
- the ability to file decisions of disciplinary panels as decisions of the court;
- statutory immunity for SROs and their staff from civil liability arising from acts done in good faith in the conduct of their regulatory responsibilities; and
- the power to seek a court-ordered "monitor" for firms that are in chronic and systemic non-compliance, close to insolvency or for other appropriate public interest criteria (only for the IDA and MFDA).

The Ontario SROs noted that similar provisions exist in the Alberta Act and urged the Committee to consider recommending similar reforms in Ontario. Two other commenters supported, in part, the Ontario SROs' submissions.[222]

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[221] See joint submission of the IDA, MFDA and RS Inc.

[222] See comment letter of Gowling Lafleur Henderson LLP and the TSX Venture Exchange. In particular, Gowlings believed that SROs should be given the authority to conduct investigations and obtain evidence from non-members, provided that this authority is made subject to the Commission's review. TSX Venture Exchange suggested that it would be useful to consider the Alberta Act, which gives SROs increased powers to conduct hearings and obtain court orders for the appointment of receivers.

In considering these issues, the Commission should consider what checks and balances, if any, are necessary to ensure procedural fairness and protections are available to those who will be subject to the new statutory powers. We believe that the Ontario SROs' submissions merit further study and consideration. Our securities regulatory regime relies heavily on the enforcement capability and regulatory expertise of recognized SROs.[223] In this regard we believe that it is critical that SROs have the necessary tools to ensure efficient and timely investigations and enforcement actions. We also believe, however, that in considering these issues, particular attention must be paid to ensuring fairness and justice in the administration of any statutory power granted to the SROs.[224] In this regard it may be necessary, for example, to build into the system appropriate checks and balances to ensure that statutory protections are afforded to those subject to the SROs' new statutory powers.

Recommendation:

We recommend that the Commission study whether the Act should be amended to give SROs the following statutory powers:

- jurisdiction over current and former members or "regulated persons" and their current and former directors, officers, partners and employees;
- the ability to compel witnesses to attend and to produce documents at disciplinary hearings;
- the ability to file decisions of disciplinary panels as decisions of the court;
- statutory immunity for SROs and their staff from civil liability arising from acts done in good faith in the conduct of their regulatory responsibilities; and
- the power to seek a court-ordered "monitor" for firms that are in chronic and systemic non-compliance, close to insolvency or for other appropriate public interest criteria.

In considering these issues, the Commission should consider what checks and balances, if any, are necessary to ensure procedural fairness and protections are available to those who will be subject to the new statutory powers.

10.7 Enforcing Compliance with Securities Laws

In the U.S., SROs are required to enforce the 1934 Act.[225] The Committee considered whether recognized SROs should have the explicit authority and obligation to enforce Ontario securities law. Section 21.6 of the Act states that no by-law, rule, regulation, policy, procedure, interpretation or practice of a recognized entity may contravene Ontario securities law, although the recognized SRO may impose more stringent requirements. As a result of this provision, SRO rules often build upon existing securities law. The recognized entity thus indirectly enforces Ontario securities law when it enforces SRO rules.

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[223] Paragraph 4 of section 2.1 of the Act directs the Commission to use, subject to an appropriate system of supervision, the enforcement capability and regulatory expertise of recognized SROs.

[224] The Committee received two comment letters that recommend that SROs should be subject to all the same legal and procedural regimes as the Commission, such as the *Canadian Charter of Rights and Freedoms*, the *Statutory Powers Procedure Act*, and the *Evidence Act* (Ontario) (see comment letters of Robert Kyle and Ken Kivenko).

[225] 1934 Act, section 6.

There would be certain efficiencies to be gained from involving SROs in compliance. SROs already perform a monitoring function with respect to their members, including monitoring to ensure compliance with the SRO's own rules and regulations.

The Committee received comments on this point prior to and following the issuance of the Draft Report. The IDA opposes requiring SROs to enforce securities law. It contends that this would result in confusion as to these roles and could further result in "double jeopardy" for registrants.[226] TSX Venture Exchange echoed this view, stating: "it is not appropriate to delegate responsibility for enforcement of securities legislation to SROs… . SROs, not being government bodies, have different burdens of proof, different evidentiary standards and different procedures than do securities Commissions."[227] TSX Venture Exchange stated that the roles of securities commissions and SROs should be kept distinct.

The Committee concluded that stock exchanges and SROs should not be required to enforce Ontario securities law for the reasons articulated by the IDA and TSX Venture Exchange. However, the Committee believes that stock exchanges and recognized SROs should be required to report immediately to the Commission any activity which appears to the SRO to contravene Ontario securities law. This would prevent stock exchanges and recognized SROs from turning a blind eye to breaches or possible breaches of the Act. In our view, this requirement should be contained in the terms and conditions of the stock exchange's or SRO's recognition order.

Recommendation:

We recommend that stock exchanges and recognized SROs be required to report to the Commission any breaches or possible breaches of securities law that they believe have occurred or may have occurred.

10.8 The Separation of Self-Interest and Self-Regulation

In our Draft Report we observed that a pressing issue surrounding the self-regulatory regime in Ontario is the potential conflict of interest between the regulatory/public interest role of an SRO and its commercial objectives. For example, in Canada the IDA is both an SRO and a trade association for investment dealers. As an SRO, the IDA regulates the capital adequacy and business conduct of investment dealers and takes enforcement action against member firms and individual salespeople for breaches of the IDA rules. It also assists regulatory authorities in developing policies designed to achieve investor protection and market efficiency.[228] As a trade association, the IDA represents the interests of member firms to federal and provincial governments and their agencies in areas such as financial institution legislation, securities regulation, and fiscal and monetary policy.[229] The IDA fulfils an advocacy function on behalf of its members and seeks "to achieve more narrow commercial objectives on the part of our members, with less focus on the broader public interest."[230]

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[226] Comment letter of the IDA.

[227] Comment letters of TSX Venture Exchange on the Issues List. Note, however, the discussion in section 10.6 where the Committee recommends consideration of whether SROs should be subject to similar statutory evidentiary standards and procedures as the Commission if SROs are given enhanced statutory investigative and enforcement powers.

The dual role of SROs presents a potential for conflict. Trade associations advocate on behalf of their members, but as a regulator, each SRO sets requirements that govern the conduct of its members. The SRO is responsible for disciplining those who have breached the requirements. In writing the Draft Report, we were concerned with whether an SRO would set standards of conduct to protect the investing public as high as an arm's-length organization might, when such standards may represent compliance challenges to its members. In addition, we questioned whether the organization would be forceful in pursuing violations of such standards and in meting out appropriate sanctions against its members. We recommended that trade association and SRO functions should be carried out by two separate bodies, each with distinct governance structures.

The Committee received a number of submissions on this matter. Commenters were divided as to whether the IDA's functions should be separated. One commenter felt that: "There is a potential for meaningful conflict, as well as an appearance of conflict between the dual roles of trade association and self-regulatory body found in SROs such as the IDA and MFDA."[231] Others did not support the recommendation. The IDA provided extensive comments on this point and met with the Committee after the Draft Report had been released. The IDA stated that it believes that "there is no meaningful conflict, beyond the conflict inherent in self-regulation, that should concern the regulators or investors."[232] Yet it recognized that there may be an appearance of conflict and stated that, as a result, a degree of "organizational distinctiveness" should be made clear with identifiable nomenclature and fire walls where appropriate.[233] The Nova Scotia Securities Commission also disagreed with our recommendation:

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[228] Comment letter of the IDA on the Issues List.

[229] This information was retrieved from the IDA's website on July 28, 2000, at www.ida.ca. The IDA made a similar point in its comment letter to the Committee on the Issues List.

[230] Comment letter of the IDA on the Issues List.

[231] See comment letter of Ontario Teachers' Pension Plan.

[232] See comment letter of the IDA.

[233] *Ibid.*

> … the IDA has significantly improved its regulatory role in the last few years. In the circumstances and in view of the significant advances recently made by the IDA, the NSSC would urge the Committee to consider whether this is the appropriate time, on a cost-benefit analysis, for the securities industry to undergo such a radical change.[234]

We have reconsidered our recommendation. We are not convinced that the benefits of forcing a split within the IDA would outweigh the costs associated with such a change. In our view, the original recommendation would occasion major structural change to the IDA and we had little evidence of either the necessity or benefits of such a change.

However, we remain concerned about an issue which was raised in comment letters on both the Issues List and the Draft Report. Investors must feel that when they have a complaint against an IDA member they receive fair and unbiased treatment from the IDA in addressing their complaint.

Since we published the Draft Report, the Financial Services OmbudsNetwork has been established to deal with, among other things, complaints by customers of investment dealers.[235] The agency operates at arm's length of all industry participants, including the IDA. Consumers who seek financial compensation because of dealings with IDA members will now avail themselves of this independent process. We feel this should address many of the concerns we heard from aggrieved investors. We would also note that investors can use the arbitration process previously established by the IDA. While the IDA was responsible for establishing the arbitration process, it is run by ADR Chambers, which is an organization that is at arm's length of the IDA.

While we are pleased with these arm's-length avenues of redress for clients of IDA member firms, we note that neither the Financial Services OmbudsNetwork nor the arbitration process deals with disciplinary matters; they continue to be handled by the IDA. The IDA advises us that there is a strict firewall between its members and its disciplinary branch which has never, to its knowledge, been breached.[236] Disciplinary hearings are held before a three-member panel. Two of the panel members are representatives of IDA members; the third member, who acts as the Chair of the panel, is a lawyer and is independent of the IDA and its members. The IDA advised us that while numerically it is possible for the IDA panel members to outvote the Chair, it rarely happens in practice.

While we are withdrawing our recommendation to separate the trade association and the regulatory functions of the IDA, we would encourage the IDA to be constantly mindful of the conflict inherent in self-regulation. The way that the IDA organizes and conducts itself must be designed to give confidence to outsiders that while the industry is policing itself, the way in which it does so is beyond reproach. The IDA's processes in investigating complaints of investors should be, and appear to be, independent of interference from members. We encourage the IDA to strive for timely and thoughtful responses to investors. We also urge the IDA to continue to consider whether improvements can be made to certain of its structures to enhance investor confidence.[237] We suggest the IDA look again at the structure of its disciplinary panels; as two-thirds of the members of a disciplinary panel are IDA member representatives, there may be concerns about the perceived independence of the panel. In addition, we note that by 2004, when changes to the IDA's Board of Directors are implemented to add more non-member directors, there will still be a majority of non-independent directors. We encourage the IDA to reconsider this allocation.

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[234] See comment letter of the Nova Scotia Securities Commission.

[235] Please see the discussion in Chapter 21.7.

[236] See comment letter of the IDA.

Recommendation:

We recommend that the IDA consider whether improvements can be made to certain of its structures, such as the composition of its disciplinary panels and the membership of its board of directors, to lessen perceptions of conflict of interest in self-regulation.

10.9 Commission Oversight

The Committee considered whether changes to the Act are required to address the SRO regulatory oversight function and provide the Commission with the tools necessary to perform its oversight function effectively. The oversight powers in the Act are comprehensive and include the power of the Commission to review and approve by-laws, to hear appeals of decisions of an SRO and to request that an SRO retain an auditor to conduct compliance reviews. In addition, SROs themselves perform annual reviews of their performance over the year.

The efficacy of the oversight function depends to a significant degree on the commitment of the Commission to actively monitor and oversee the activities of SROs. Nothing has come to the Committee's attention to indicate that the oversight function of the Commission is not working properly. In its Statement of Priorities for the 2001-02 fiscal year, the Commission stated that it seeks to increase its presence and effectiveness through various compliance monitoring and enforcement activities, including developing and implementing a comprehensive risk-based approach to compliance which will result in more effective Commission oversight of SROs; increasing resources allocated to SRO oversight activities; conducting examinations of SROs; continuing to oversee the regulatory functions of the IDA and work with the IDA to improve any perceived deficiencies; and providing the MFDA with reasonable implementation support.

The Committee therefore believes that the Act provides sufficient legislative tools to enable the Commission to perform its SRO oversight function. In addition, the Commission has increased its emphasis on the oversight function, making regulatory oversight one of its priorities. Thus, the Committee sees no need for additional oversight powers at this time.

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[237] In Chapter 21, we note recent commitments by the IDA to enhance transparency in relation to its arbitration program.

PART 4

REGULATING ISSUERS: DISCLOSURE, THE CLOSED SYSTEM AND CORPORATE GOVERNANCE

Enron collapsed in the fall of 2001. Its demise is being attributed, among other things, to its governance, accounting and disclosure practices. In this Part, we discuss whether the Act imposes disclosure obligations on public companies that are adequate to ensure that investors in the secondary markets can make informed decisions and have confidence in the reliability of corporate disclosure. We also discuss the existing "closed system" and how the regulation of exempt offerings and hold periods restricts access to secondary market liquidity. We consider how the "closed system" could be simplified without undermining investor protection and capital markets efficiency.

We have made the case earlier in this report for the importance of Canadian capital markets being competitive on a global basis. Because capital formation is not constrained by national borders, it is critical that Canada be perceived, both domestically and abroad, as being a fair and safe place to invest. This in turn depends upon the emphasis we place on the integrity of our continuous disclosure system. When it comes to disclosure standards, we should strive to be "best in class."

CONTINUOUS DISCLOSURE

11.1 The Importance of Continuous Disclosure

One of the core requirements in the Act is that an issuer must provide a prospectus to prospective purchasers before it may sell securities to them.[238] The prospectus must provide full, true and plain disclosure of all "material facts"[239] relating to the securities to be issued. This is intended to allow the prospective purchaser to make an informed investment decision.

Once securities have been issued under a prospectus, they are "freely tradeable." In other words, investors may sell the securities they hold in the "secondary market" without providing a prospectus or any other information about the securities or the issuer to the purchaser.
A secondary market purchaser relies on the "public record," which consists of the prospectus and all of the information the issuer has been required to deliver to shareholders or file with the Commission pursuant to the "continuous disclosure" regime in the Act.

Secondary market trading now accounts for approximately 95 per cent of all capital markets trading in Ontario.[240] In order for investors to be prepared to buy securities in the secondary market in Ontario, they must be confident that the public record will provide them with reliable information on a timely basis.[241] This chapter discusses the current continuous disclosure regime and the Commission's role in monitoring and enforcing disclosure requirements.

11.2 The Current Regime

The Act requires reporting issuers to make certain disclosure on a regular basis throughout the year. This "periodic disclosure" is described below (in subsection 11.2(a)). Other disclosure must be made upon the occurrence of certain events. This "event-driven disclosure" is described in subsection 11.2(b) below. The theory is that the "material facts" disclosed in the prospectus, taken together with all "material changes" that have been disclosed since the date of the prospectus and all other information that forms a part of the issuer's continuous disclosure record, will keep the investing public current.

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[238] The Act, subsection 53(1). More specifically, a prospectus is required if a trade is a "distribution." A "distribution" is defined in subsection 1(1) of the Act and includes "a trade in securities of an issuer that have not been previously issued." The Act provides certain exemptions to this prospectus requirement, discussed in Chapter 12 of this Report.

[239] The meaning of "material fact" is defined in subsection 1(1) of the Act.

[240] CSA Notice 53-302 *Proposals for a Statutory Civil Remedy for Investors in the Secondary Market and Response to the Proposed Change to the Definitions of "Material Fact" and "Material Change"* (2000), 23 OSCB 7383 at Section II, "Background."

[241] Under the existing regime, primary market investors have a statutory right to seek damages from issuers and others for losses attributable to a misrepresentation in a prospectus without having to prove reliance, which is required under existing common law rights of action. Secondary market purchasers donot have any statutory rights of actions for misrepresentations.

A) PERIODIC DISCLOSURE

The following is the disclosure that a reporting issuer is required to make each year.

- A reporting issuer must send quarterly financial statements (accompanied by MD&A) to its shareholders.[242]
- A reporting issuer must prepare and send to its shareholders, and file with the Commission, annual audited financial statements (accompanied by MD&A) no later than 140 days after year end.
- Most issuers are also required to file an AIF with the Commission each year.[243] The AIF provides much of the same information contained in a prospectus and in this way refreshes the narrative description of the issuer and its business on an annual basis.
- Management must send a form of proxy and a management information circular to each shareholder in advance of every shareholder meeting (both annual and special). The circular must provide shareholders with information to help them make informed judgements about the matters being voted on at a meeting. The circular also must contain information about:
    - director and executive compensation;
    - indebtedness of officers and directors;
    - interests of insiders in material transactions; and
    - details relating to management contracts.

B) EVENT-DRIVEN DISCLOSURE

Reporting issuers and their insiders must also make certain disclosure from time to time:

- the Act requires reporting issuers to disclose "material changes" by issuing a press release describing the change (and filing a material change report with the Commission); and

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[242] OSC Rule 52-501 *Financial Statements* (2000), 23 OSCB 8372 requires reporting issuers to include an income statement, statement of retained earnings and cash flow statement in interim financial statements for the current quarter, as well as an interim balance sheet and explanatory notes to the interim financial statements. A company's board of directors (or its audit committee) is required to review the interim financial statements before they are filed with the Commission. Companies are encouraged to consider retaining external auditors to review such statements. OSC Rule 51-501 *AIF and MD&A* (2000), 23 OSCB 8365 as amended (2001), 24 OSCB 7417 requires management to provide a narrative discussion and analysis (MD&A) of interim financial results together with interim financial statements.

[243] Under OSC Rule 51-501 *AIF and MD&A*, each reporting issuer, other than a mutual fund, is required to file an AIF if either its shareholders' equity or revenues exceeded $10,000,000 in each of the three immediately preceding financial years, or if the aggregate market value of its outstanding equity securities for which there was a published market was more than $75,000,000 on the last day of each of the three immediately preceding financial years.

- anyone who is an "insider" (typically directors, senior officers and shareholders with 10 per cent or more of the company's outstanding voting shares) must file a report within 10 days of the day on which they became an insider and after that must file a supplementary report within 10 days after they have traded their shares in the company.

11.3 Alternative Approaches to Regulation Which Emphasize the Secondary Market

We reviewed two alternative proposed models to regulation which emphasize the secondary market.

A) INTEGRATED DISCLOSURE SYSTEM

In 2000, the CSA issued a concept proposal for an IDS. Under the IDS, issuers would be required to prepare and file enhanced continuous disclosure documents that would be available to all investors. Once these documents have been filed, issuers would be able to take advantage of a streamlined process for issuing securities that would consist of a "term sheet" summarizing the terms of the securities being offered and would incorporate the continuous disclosure record of the issuer by reference. This would enhance the quality and timeliness of continuous disclosure information available to investors while providing issuers with a more efficient process for clearing prospectus offerings.[244]

The primary aim of the IDS is to de-emphasize the prospectus as the issuer's cornerstone disclosure document and emphasize instead the quality of the issuer's ongoing continuous disclosure base.[245] Under the IDS:

- investors in the secondary and exempt markets would have access to enhanced public disclosure;
- issuers could go to market more quickly with new securities issues; and
- issuers could raise capital at a reasonable cost without compromising investor protection.

B) THE COMPANY REGISTRATION MODEL

We also considered the company registration model proposed by the Wallman Report in the U.S. in 1996. Under this model, companies would file a generic document similar to an AIF so that information about the issuer and its operations would be on the public record. When the issuer wants to issue additional securities, only information about those securities would be required since information about the issuer itself is already on the public file. Issuers would benefit from the reduced transactional costs and greater flexibility associated with a streamlined registration process.

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[244] See CSA Notice and Request for Comment, 44-401, 51-401 *Concept Proposal for an Integrated Disclosure System* (2000), 23 OSCB 633.

[245] Historically, the focus of securities legislation has been on the prospectus rather than continuous disclosure. IDS proposes to change this by decoupling the prospectus from relatively constant information describing the issuer. This information, known as the disclosure base, would be incorporated by reference into an abbreviated offering document whenever an issuer wanted to raise additional capital. A shortened prospectus would allow an issuer to quickly take advantage of market conditions to raise capital.

The registration model is similar to the IDS discussed above. We note that the SEC has not adopted the approach recommended in the Wallman Report; however, we believe there is merit to this approach and the proposed IDS and the shift in focus they represent.

11.4 How Is Continuous Disclosure Monitored and Enforced?

There had been no regular review of the continuous disclosure practices of reporting issuers until January 1999, when the Commission created a continuous disclosure team (the "CD Team"). The CD Team reviews continuous disclosure filings made by reporting issuers, issues comment letters similar to those provided in the prospectus review process, and monitors external sources for possible disclosure deficiencies.[246] The CD Team performs two functions. First, it monitors compliance with statutory requirements, putting the Commission in a position to take action against reporting issuers who fail to comply. Second, because of the dialogue in which it engages with reporting issuers, the CD Team has begun to play an important role in helping reporting issuers understand their continuous disclosure obligations.

Sanctions under the Act for failure to comply with continuous disclosure requirements are no different from those applicable to any other breach of the Act. If it is determined that an issuer's disclosure is so deficient as to constitute a default, it may be placed on the defaulting issuer's list.[247] The CD Team may initiate a hearing before the Commission under section 127 of the Act, and the Commission may require the issuer to amend its disclosure.[248]

The review of an issuer's continuous disclosure record is not unlike the review that other Commission staff conducts with respect to a prospectus. However, in the prospectus context, the Director has the ability to refuse a receipt for a prospectus under prescribed circumstances. The CD Team has no similar means of encouraging an issuer to respond to the issues it raises. The Act does not specifically contemplate continuous disclosure reviews (as it does prospectus reviews[249] and compliance reviews[250]). We believe that statutory recognition of continuous disclosure reviews is appropriate to emphasize the importance of continuous disclosure obligations in the current environment.[251] We also note that most commenters support statutory recognition of continuous disclosure reviews.[252] In addition, civil liability for continuous disclosure (discussed below) will provide an important additional incentive for issuers, whose disclosure practices are lacking, to respond to issues raised with them by the CD Team.

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[246] See OSC Staff Notice 51-703 *Implementation of Reporting Issuer Continuous Disclosure Review Program* (2000), 23 OSCB 4123. In March 2003 the Commission's Investment Funds Branch will introduce a continuous disclosure review program for all investment funds. OSC Staff Notice 81-705 *Implementation of a Continuous Disclosure Review Program for Investment Funds* (2003), 26 OSCB 1757.

[247] OSC Policy 51-601 *Reporting Issuer Defaults* (2001), 24 OSCB 6587, paragraph 3.3(2)4.

[248] The Act, paragraph 127(1)5.

[249] The Act, section 61.

[250] The Act, section 20.

In our Draft Report we recommended that the concept of continuous disclosure reviews be enshrined in the Act. We are pleased that the Government of Ontario has shown its support for our recommendation in this regard by incorporating this recommendation in legislation passed in December 2002.[253] We also note that the 2002 Amendments will give the Commission the power in the context of a continuous disclosure review to request that issuers provide internal documents for review by the Commission. Information so received by the Commission is exempt from access under the *Freedom of Information and Protection of Privacy Act* if the Commission determines that the information should be maintained in confidence. We believe that these amendments are helpful in two ways. First, the amendments will permit the Commission to ask issuers for additional information that may assist Staff with its review without the necessity for the Commission to issue a formal investigation order – with the resulting stigma that may be seen to attach to such orders. Also, the amendments will provide assurances to reporting companies that highly confidential information given to the Commission will be kept out of the public domain where such disclosure could reasonably be expected to prejudice a company's competitive position or result in undue loss to a company.

While we endorse the Government of Ontario's decision to give the Commission such additional powers, we nonetheless urge the Commission to exercise restraint and caution when using them. In its recent review of TSX 100 companies that are based in Ontario, we understand that the Commission requested non-public corporate information in advance of reviewing a company's public disclosure record and in the absence of any specific concerns about a company's disclosure. This initiative, while unusual, was undertaken to accelerate the pace and increase the vigilance of reviews of Ontario's largest companies because of their impact on Ontario's capital markets.[254] The review was part of the Commission's overall initiative to boost investor confidence in light of recent U.S. corporate failures. While the Committee acknowledges that rebuilding investor confidence is a worthy objective, in general we do not agree with the review process that was undertaken. Our recommendation in the Draft Report was intended to give statutory recognition to a very important Commission function and should not be construed as an invitation for the Commission to engage in a "fishing expedition."

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[251] We note that the *Sarbanes-Oxley Act of 2002* requires the SEC to conduct "regular and systematic" reviews of every public company, at least every three years.

[252] See comment letters of Certified General Accountants of Ontario, Ontario Teachers' Pension Plan, Fasken Martineau DuMoulin LLP, and the Securities Subcommittee of the Ontario Bar Association.

[253] See section 179 of the 2002 Amendments.

[254] "OSC Increases Continuous Disclosure Reviews – More Staff, Higher Targets, Deficient Companies to be Named", (2002), 25 OSCB 5700.

11.5 Harmonization Issues

There is no harmonized approach to continuous disclosure across Canada. For example, there are differences among the provinces and territories in the following areas:

- the definition of "material change";
- requirements relating to the preparation and filing of material change reports;
- the definition of "insider";
- requirements relating to insider reporting;
- the deadlines for filing financial statements;
- requirements relating to the filing of quarterly financial statements;
- financial statement standards;
- requirements relating to MD&A; and
- the requirement to file an AIF.

We have made our case in Part I for the importance of cross-Canada harmonization in securities regulation, including continuous disclosure. To this end, we note that in June 2002, the CSA published for comment proposed National Instrument 51-102 *Continuous Disclosure Obligations*. The proposed national instrument is intended to:

- harmonize continuous disclosure requirements among Canadian jurisdictions;
- replace existing local continuous disclosure requirements;
- enhance the consistency of disclosure in the primary and secondary securities markets; and
- facilitate capital-raising initiatives such as an integrated disclosure system.

We are strongly supportive of this initiative and encourage the CSA to assign a high priority to this proposal to ensure its timely adoption across Canada. We agree with the approach adopted by the CSA whereby requirements are harmonized according to different tiers of issuers. Some requirements may be too onerous for junior issuers. It might be necessary to impose different disclosure requirements for junior issuers to better match the realities of their business and state of development in order to provide more meaningful disclosure to the marketplace.

Recommendation:

We strongly support the CSA's initiative to harmonize Canadian continuous disclosure requirements and encourage the CSA to assign a high priority to this proposal to ensure its timely adoption across Canada.

11.6 Civil Liability for Continuous Disclosure

In our Draft Report, we recommended that the Government of Ontario enact legislation imposing civil liability for continuous disclosure that had been under consideration for some time. In December 2002, the Government of Ontario enacted this legislation as part of its investor confidence legislation. This section describes the background to the enactment of this legislation.

A) BACKGROUND

Over the past three decades, there have been a number of proposals to extend statutory civil liability to continuous disclosure. In 1979, the federal *Proposals for a Securities Market Law of Canada* recommended, among other things, a statutory civil liability regime covering continuous disclosure.[255] The 1979 federal proposals were not adopted. In 1984, the Commission recommended legislative amendments that would have extended statutory civil liability to continuous disclosure documents.[256]

In December 1994, the Dey Committee recommended that the issue of legislated civil liability with respect to timely and continuous disclosure should be put back on the policy agenda.[257] Shortly thereafter, the Allen Committee was appointed. The Allen Committee's mandate was to review continuous disclosure by Canadian public companies and to evaluate the adequacy of such disclosure. It was also asked to consider whether additional remedies should be available, either to regulators or to investors, if issuers breach their continuous disclosure obligations.

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[255] P. Anisman, J. Howard, W. Grover & J.P. Williamson, *Proposals for a Securities Market Law for Canada*, (Ottawa: Minister of Supply and Services, Canada, 1979).

[256] "Civil Liability for Continuous Disclosure Documents Filed under the *Securities Act* – Request for Comments," (1984), 7 OSCB 4910.
Similarly, in 1994 the B.C. government developed a proposal to introduce a limited scheme of civil liability for certain disclosure in response to the Matkin Inquiry and recommendations reflected in the Matkin Report (J.G. Matkin & G.G. Cowper, *Restructuring for the Future: Towards a Fairer Venture Capital Market*, Report of the Vancouver Stock Exchange & Securities Regulation Commission (1994)). However, by this time, the Allen Committee had been established and the B.C. government agreed to await the release of that committee's report with the hope that any eventual recommendations could be adopted nationally.

[257] *"Where Were The Directors? Guidelines for Improved Corporate Governance in Canada."* Report of The Toronto Stock Exchange Committee on Corporate Governance in Canada (December, 1994).

The Allen Committee issued its report in March 1997, concluding that there was evidence of a significant number of incidents of disclosure violations and perceived problems with the adequacy of continuous disclosure in Canada. It expressed concern that these circumstances could tarnish the reputation of our capital markets with resulting loss of investor confidence. This would also have direct cost implications for Canadian companies.

Finally, in January 1999, the Mining Standards Task Force released its report entitled *Setting New Standards: Recommendations for Public Mineral Exploration and Mining Companies.*[258] It endorsed the recommendations of the Allen Committee relating to statutory civil liability for misleading continuous disclosure as a positive step toward ensuring effective accountability of companies for disclosure relating to mineral exploration, development and production.

B) STATUTORY CIVIL LIABILITY – DRAFT LEGISLATION AND THE GOVERNMENT OF ONTARIO'S RESPONSE

On November 3, 2000, the CSA published draft legislative amendments which would create a statutory civil liability regime for continuous disclosure.[259] These Civil Liability Amendments were based largely on the recommendations contained in the Allen Report. In December 2002, the Government of Ontario passed legislation that generally mirrored the Civil Liability Amendments.[260] Once these amendments have been proclaimed into force, they will give investors in the secondary market the right to sue any public company and other responsible parties[261] for making a public material misrepresentation,[262] written or oral, about the company or for failing to make required timely disclosure.[263]

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[258] Published January 1999 by the TSX and the Commission. The Task Force was a joint task force between the Commission and the TSX.

[259] The Civil Liability Amendments were "primarily directed to providing a deterrent to misrepresentations and failures to make timely disclosure." In this regard, the Civil Liability Amendments contained liability caps which varied between different categories of defendants. For an issuer, the liability cap was set at the greater of $1,000,000 or five per cent of the company's market capitalization. See CSA Notice 53-302 Proposal for a Statutory Civil Remedy for Investors in the Secondary Market and Response to the Proposed Change to the Definitions of "Material Fact" and "Material Change" (2000), 23 OSCB 7383.

[260] See section 198 of the 2002 Amendments.

[261] Other potential defendants include director, officers, "influential persons" (including control persons, promoters, insiders, and investment fund managers), and experts (including auditors).

[262] A misrepresentation is defined under subsection 1(1) of the Act as: "(a) an untrue statement of material fact, or (b) an omission to state a material fact that is required to be stated or that is necessary to make a statement not misleading in light of the circumstances in which it was made."

[263] Defendants have several potential defences under the Civil Liability Amendments. For example, every defendant has a due diligence defence by proving that they conducted or caused to be conducted a reasonable investigation and that they had no reasonable grounds to believe that the document or public oral statement contained a misrepresentation, or that the failure to make timely disclosure would occur. There is also no liability for failing to make timely disclosure if the issuer filed a confidential material change report and other requirements are met. Defendants may also limit their potential liability for continuous disclosure violations made without their knowledge by taking corrective action. The Civil Liability Amendments also contain a "safe harbour" for forward-looking information.

There was considerable opposition to the Civil Liability Amendments when they were first released for comment, primarily from public companies.[264] The major concern focused on the costs to public companies, their directors and, ultimately, their shareholders, of having to defend against unmeritorious class actions. In response to this concern, the CSA made a number of changes to the Civil Liability Amendments, including the introduction of certain procedural mechanisms designed to screen out unmeritorious actions.[265] The CSA believe that these new procedural mechanisms, together with the "loser pays" cost and proportionate liability provisions, "should ensure that any exercise of the statutory right of action occurs in a litigation environment … less conducive to coercive strike suits."[266] A relatively recent Ontario decision suggests that the courts will have little patience with American-style strike suits.[267]

In our Draft Report, we concluded that the case for statutory liability had been made. The Government of Ontario has indicated their support for the legislation by introducing and passing it in the fall 2002 legislative session. We urge the Government of Ontario to proclaim the legislative amendments in force on a priority basis. In this regard, we note that we received many submissions from commenters who strongly support the passage of the Civil Liability Amendments.[268] One commenter noted:

> Issuers should regard the Civil Liability Amendments' procedural mechanisms and limitations on liability as a preferable alternative to the indeterminate outcomes that may arise from class action proceedings brought outside of the Civil Liability Amendments. As well, the competitiveness of the Canadian capital markets depends, in part, on the ability to demonstrate that Canadian securities laws are as protective of investors' rights as those in other major markets. Accordingly, we agree with the Committee that the CSA's proposal to create a statutory civil liability regime for continuous disclosure should move forward.[269]

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[264] The Civil Liability Amendments were published for comment in May 1998 (see (1998), 21 OSCB 3367).

[265] For example, the Civil Liability Amendments require a plaintiff to obtain leave of the court in order to bring an action. Before granting leave, the court must be satisfied that the action (i) is being brought in good faith and (ii) has a reasonable prospect of success at trial. The Civil Liability Amendments also require court approval before any action can be settled.

[266] We note that, more recently, some observers who primarily represent the plaintiff bar have questioned whether the Civil Liability Amendments, when implemented, will be used by class action plaintiffs and, in such event, whether they will pose an effective deterrent.

[267] See, for example, *Epstein v. First Marathon Inc.*, [2000] 2 B.L.R. (3d) 30 (Ont. S.C.), where the court denounced American-style strike suits. The court used its powers under the *Ontario Class Proceedings Act, 1992*, S.O. 1992, c. 6, which requires court approval of any settlement of a class proceeding commenced under the Act, to disallow a proposed settlement agreement which would have provided no benefit to the proposed shareholder class and a substantial payment to class counsel. Cumming J. held that approval of the settlement "would violate the public policy objectives underlying the legislature's enactment of the [Act]", and that the "plaintiff's class proceeding is counter-productive to all these objectives."

[268] See comment letters of the Certified General Accountants of Ontario, Ontario New Democratic Party, Fasken Martineau DuMoulin LLP, Ontario Teachers' Pension Plan, PricewaterhouseCoopers LLP, the Investment Dealers Association , the Canadian Institute of Chartered Accounts, Canadian Investor Relations Institute, and BMO Nesbitt Burns.

[269] See comment letter of Fasken Martineau DuMoulin LLP.

We note that the BCSC recently published a revised civil liability proposal as part of its "New Proposals for Securities Regulation."[270] The BCSC's draft legislation proposes to make several changes to the Civil Liability Amendments. We view the BCSC's revised draft legislation as an unfortunate step backwards from the CSA's efforts to achieve uniformity in a critical area. Now that the CSA's draft legislation has been introduced and passed in Ontario, we encourage other provincial and territorial governments to adopt uniform legislation in their jurisdictions as well.

Finally, we received two comment letters urging the Committee to recommend certain changes to the primary offering civil liability regime to parallel the Civil Liability Amendments, such as the introduction of a proportionate liability regime.[271] One commenter noted that:

> The issue is particularly acute as the CSA move towards an integrated disclosure system whereby continuous disclosure documents are referenced in primary documents for securities offerings. A party can be engaged for continuous disclosure purposes, under the understanding that although there is a liability risk, there is a statutory ... apportionment of damages. However, that party can be seriously harmed when the same document may be incorporated into a prospectus at a later date, at risk of ... joint and several liability. Arguably, the party might be able to disassociate himself from the subsequent use of the document. However, if practiced on a broad basis, this could seriously affect the efficient functioning of the capital markets.[272]

We believe that there are fundamental differences between primary and secondary offerings which should be taken into account when fashioning a civil remedy for investors in the primary and secondary markets. For example, in a primary offering, an issuer receives funds from the offering that can be used to compensate investors who have bought securities from the issuer and who have been prejudiced by a misrepresentation in a prospectus. In secondary market trading, an issuer receives no proceeds and it is ultimately the shareholders of the company who will bear the costs of a damages award against the issuer where there has been a misrepresentation in a continuous disclosure document. Despite these differences, however, we also believe that the passage of the Civil Liability Amendments necessitates a re-examination of some of the elements of the existing primary offering civil liability regime. In particular, we recommended that the Commission study the appropriateness of amending the existing primary offering civil liability regime to parallel the Civil Liability Amendments in the following areas:

- changing the joint and several liability scheme to a proportionate liability scheme whereby each defendant is liable only for such defendant's proportionate share of the total damages awarded to the plaintiff;
- extending a due diligence defence to the issuer; and
- introducing a safe harbour for forward-looking information.

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[270] BCSC, "New Proposals for Securities Regulation – A New Way to Regulate" (June 5, 2002) (www.bcsc.bc.ca).

[271] See comment letters of the Canadian Institute of Chartered Accountants and PricewaterhouseCoopers LLP.

[272] See comment letter of PricewaterhouseCoopers LLP.

While we make no specific recommendations as to whether any changes are appropriate, we believe that study is warranted.

Recommendations:

1. We support the CSA proposal to create a statutory civil liability regime for continuous disclosure and urge the Government of Ontario to move forward as soon as possible to proclaim the legislation in force. We also encourage the governments of the other CSA jurisdictions to adopt the same regime.

2. We recommend that the Commission study the appropriateness of amending the existing primary offering civil liability regime to parallel the Civil Liability Amendments in the following areas:

   - changing the joint and several liability scheme to a proportionate liability scheme;
   - extending a due diligence defence to the issuer; and
   - introducing a safe harbour for forward-looking information.

THE CLOSED SYSTEM

The closed system has been a cornerstone of our prospectus exemption system for over 20 years. While the closed system was never easy to grasp, over the years it has become increasingly complicated and difficult to administer and comply with. This is largely due to the fact that previous blanket rulings (now rules) add and remove prospectus exemptions and vary hold periods that would otherwise apply under the Act. In addition, other provinces also have closed systems, but with different exemptions and rules relating to hold periods. Accordingly, we considered whether the closed system should be replaced with an alternative approach, or whether certain aspects of it should be modified or eliminated. As part of this analysis, we considered whether hold period and seasoning period restrictions are necessary. Peripherally, we also considered the existing prospectus exemptions and the need for uniformity in this regard across Canada.

12.1 What Is the Closed System?

The requirement to issue a prospectus serves an important function. It requires the issuer to provide certain information to prospective investors to assist them in making their investment decision. In addition, the prospectus must be filed on SEDAR, which makes it generally available to the marketplace. There are, however, situations in which investors either do not need the information set out in the prospectus or are able to obtain that information themselves through direct discussion with the issuer. In these situations, the Act allows the issuer to avoid the time and expense of preparing a prospectus.

Prior to 1979, a prospectus was required if an issuer made a "distribution to the public." There was considerable confusion about the meaning of this phrase and, in particular, who constituted a member of "the public." In order to provide greater certainty about when a prospectus is required, the concept of a distribution to the public was eliminated and the "closed system" was introduced. Under the closed system, a prospectus is required for all distributions of securities unless a specific prospectus exemption is available. Securities issued pursuant to an exemption can be traded using a further exemption, but the system is "closed," in that trades of those securities outside the exemption system are prohibited unless a prospectus is filed and receipted or certain resale restrictions are satisfied. In this way, securities issued pursuant to a prospectus exemption become part of the "closed system" and are restricted from entering the secondary market. Generally, securities issued pursuant to an exemption can only be traded outside of the closed system (or in other words, become "freely tradeable") if the issuer is or has been a reporting issuer for a specified period of time and in some cases, subject to the further restriction that the securities have been held for a period of time.[273]

There are two aspects of the closed system that are critical to understanding how it works: "hold periods" and "seasoning periods." "Hold periods" apply to securities acquired under certain prospectus exemptions, which prohibited them from being resold until they had been held for the required period of time. The rationale for hold periods is discussed in section 12.3. The hold periods of 6, 12 or 18 months were replaced in 2001 when the CSA introduced uniform hold periods to replace local hold periods in the various provincial statutes. These new hold periods provide that securities acquired under prospectus exemptions cannot be resold until the later of four months (in the case of a qualifying issuer) or 12 months (for a non-qualifying issuer) after the date of the exempt trade or the date upon which the issuer becomes a reporting issuer.[274] Distributions of securities from a control block are permitted to be made without a prospectus, subject to compliance with hold periods, provided that the control block party gives the market advance notice by filing a notice of intention to sell and the seller certifies certain facts.

Certain prospectus exempt trades do not attract hold periods but they are subject instead to "seasoning periods." Under the Act, securities acquired pursuant to prospectus exemptions which are subject to seasoning periods only become freely tradeable if the issuer has been a reporting issuer for at least 12 months and is not in default of any requirement under the Act. The rationale for seasoning periods is that, since the issuer has been a reporting issuer for at least one year, it has established a sufficient disclosure record so that purchasers do not require prospectus-level disclosure. Multilateral Instrument 45-102 *Resale of Securities* harmonizes seasoning periods across the country, replacing the 12-month seasoning period under the Act with either a four-month (for qualifying issuers) or 12-month seasoning period (for non-qualifying issuers).

12.2 Problems with the Closed System

Under the closed system, every distribution of a security either requires a prospectus or falls within a specific exemption. The certainty that this approach provides has come at a high cost in terms of complexity and inefficiency. The legislation cannot capture all of the conceivable transactions that fit within the policy objectives of the exemptions. Accordingly, issuers must apply for discretionary exemptive relief for specific transactions which may be similar to, but do not fit within the four corners of, available statutory exemptions. This adds time and expense to issuers' transactions. Commissions across the country must, in turn, spend considerable time and effort dealing with these applications for discretionary relief. When a specific type of transaction becomes commonplace, this gives rise to the need for recurring relief, because the Commission no longer has the ability to issue blanket rulings. It is difficult to see how the Act's twin goals of investor protection and enhancing capital markets efficiency are supported through this process. In Chapter 7 of this Report, we recommend that the Commission be vested with the power to issue blanket orders.

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[273] In order to become a "reporting issuer," a company is generally required either to file a prospectus or become listed on an exchange in Ontario recognized by the Commission.

[274] Multilateral Instrument 45-102 *Resale of Securities* (2001), 24 OSCB 7029.

Hold periods and seasoning periods make the resale of securities issued under prospectus exemptions a very complex matter requiring expert legal advice. While the implementation of MI 45-102 has helped to force greater convergence of hold period and seasoning period requirements in closed system jurisdictions, prospectus exemptions and resale restrictions continue to differ from province to province.

Prospectus exemptions have always varied across Canada. Recent reforms in Ontario, British Columbia and Alberta illustrate how regulators are continuing to move in different directions.[275] Instead of harmonizing and simplifying the regime for raising capital in Canada, these divergent local initiatives have exacerbated the differences between the exemptions available across the country, in turn increasing the cost and complexity of exempt offerings across Canada. Local considerations and differences in regional markets are often cited as the reason for differences in the nature of the prospectus exemptions provided for under local legislation. We believe that local considerations can be reflected in a single, harmonized set of exemptions that are available across the country. We note that many commenters shared our concerns regarding the state of the closed system and the problems caused by unique local rules governing prospectus exemptions.[276]

Recommendation:

We encourage the CSA to proceed with further reforms to the prospectus exemptions and the closed system with the goal of harmonizing and simplifying the requirements relating to private placements.

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[275] See OSC Rule 45-501 *Exempt Distributions*, as contrasted with the new exemptions in British Columbia and Alberta: the "family, friends and business associates exemption," the "offering memorandum exemption," the "accredited investor exemption" and a modified "private issuer exemption" (Multilateral Instrument 45-103 *Capital Raising Exemptions*). These exemptions replaced a number of existing exemptions, including the "50 purchaser exemption," the "$25,000 sophisticated purchaser exemption" and the "friends and relatives exemption." In November 2002, MI 45-103 was published for comment in amended form (See BCN 2002/39 "Proposed Amendments of Multilateral Instrument 45-103 Capital Raising Exemptions and Proposed Adoption in Additional Jurisdictions"). When finalized, it will also apply in Manitoba, Newfoundland, Northwest Territories, Nunavut, Prince Edward Island and Saskatchewan, although there will be certain differences among these jurisdictions regarding the offering memorandum exemption.

[276] See comment letters of the Canadian Bankers Association, Royal Bank of Canada, TSX Venture Exchange, IDA and TSX.

12.3 Recent Reforms to the Exempt Market Regime and the Resale Rules: Do They Go Far Enough?

A) EXEMPT MARKET REFORM

The closed system is based on specific exemptions from the prospectus requirement. The Act and subordinate legislation currently contain over 40 such exemptions. Some of these exemptions have been consolidated in OSC Rule 45-501 *Exempt Distributions*, which has effectively replaced various exemptions in the Act. OSC Rule 45-501 introduced two new exemptions–the "closely held issuer exemption" and the "accredited investor exemption." The private company exemption,[277] private issuer exemption,[278] $150,000 exemption,[279] and seed capital exemption[280] are no longer available in Ontario.

The recent exempt market reform in Ontario was largely based on the recommendations of *The Report of the OSC Task Force on Small and Medium Sized Businesses.*[281] British Columbia and Alberta have also recently undertaken exempt market reform (see footnote 275). In June 2002, the BCSC released a paper entitled "New Proposals for Securities Regulation – A New Way to Regulate" for comment. The paper builds on the CSA's IDS proposals discussed in Chapter 11 by proposing a continuous market access system (CMA). Under the CMA, prospectuses would be replaced by an "evergreen" continuous disclosure system, eliminating the need for prospectus exemptions or resale restrictions for CMA issuers.

We believe that simplifying the exempt market regime and achieving harmonization across Canada is an important first step, even if it is only an interim step, toward a more radical, eventual overhaul of the regime. We do not propose eliminating the closed system in its entirety, but we do wonder whether certain aspects of the closed system (in particular, hold periods and seasoning periods) could be significantly streamlined and, in certain cases, eliminated.

B) CONTINUED NEED FOR HOLD PERIODS

In the previous section, we described recent reforms aimed at harmonizing and reducing the length of the hold periods that apply to prospectus exempt trades. In this section, we ask whether reform should go further: do hold periods continue to be necessary at all? In addressing this question, the Committee considered the various rationales underlying hold periods.

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[277] The Act, paragraph 35(2)10 and subsection 73(1).

[278] OSC Rule 45-501, section 2.17.

[279] The Act, paragraph 35(1)5 and clause 72(1)(d).

[280] The Act, paragraph 35(1)21 and clause 72(1)(p).

[281] (1996), 19 OSCB 5757.

We identified three rationales for hold periods:

1. Hold periods prevent what are referred to as "back-door underwritings" – the use of a private placement exemption to effect a public distribution without preparing a prospectus.[282] Hold periods prevent an issuer from privately placing securities for immediate resale to the public without the benefits of a prospectus standard of disclosure and the rights and obligations that flow from the prospectus.

2. Hold periods protect investors by ensuring that information about the issuer is available and disseminated in the marketplace through the issuer's continuous disclosure filings prior to permitting resale of the restricted securities.

3. Hold periods create an incentive for issuers to complete a public offering by reducing the price the private placee will pay for the securities given that they are not freely tradeable. In theory, public financings also afford the investing public the greatest protection since a prospectus, with the liability and resultant due diligence it attracts, is filed.

With respect to the back-door underwriting issue, this concern could be addressed in a more targeted fashion. If private placees acquire securities with a view to distribution, this may bring them within the definition of "underwriter" under the Act and subject to the associated requirements. The definition of distribution could be tightened up to capture only those exempt trades which are "back-door underwritings" and make them subject to an appropriate hold period.

The second rationale for hold periods described above is not particularly compelling today. The gap in the quality of disclosure as between the prospectus and continuous disclosure that existed when the closed system was introduced has narrowed considerably through regulatory reforms over the intervening period. In addition, while this suggested rationale for hold periods may support the need for seasoning periods, it does little to explain why hold periods apply even where an issuer has been a reporting issuer for a long period of time.

Lastly, there does not appear to be a compelling reason to retain hold periods in order to discourage issuers from doing exempt offerings in favour of prospectus offerings. In our view, the key is to implement other reforms such as civil liability for continuous disclosure, upgrading of continuous disclosure standards and moving toward a more integrated disclosure system so that opportunities for regulatory arbitrage between private and public means of financings are reduced, if not eliminated.

The CSA recently made great strides in reducing and simplifying hold periods to four months for qualifying issuers and 12 months for non-qualifying issuers. As illustrated above, however, the rationale for hold periods is not as compelling as it once was. Once the other reforms we contemplate are in place, it may be time to take the next logical step and eliminate hold periods for reporting issuers except in instances where "back-door underwriting" continues to be a concern.[283]

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[282] See the Merger Report, *supra* note 9.

Recommendation:

Once other reforms are implemented, such as civil liability for continuous disclosure, enhanced continuous disclosure standards for all reporting issuers, and a more integrated disclosure system overall, we believe hold periods for securities of reporting issuers could be eliminated without sacrificing investor protection while contributing significantly to more efficient capital markets.

C) CONTINUED NEED FOR SEASONING PERIODS

Seasoning periods ensure that prospectus-level disclosure has been publicly available for a minimum period before securities of a reporting issuer acquired under a prospectus exemption may be traded outside of the closed system.

There are two elements of the seasoning period: the issuer must be a reporting issuer; and it must have been a reporting issuer for some minimum period of time before its securities can be traded outside of the closed system.

One commenter on our Issues List made the following comment about seasoning periods:

> The requirement that an issuer be a reporting issuer ensures that the issuer is subject to continuous disclosure requirements so that a purchaser in the secondary market will have the benefit of the continuous disclosure record. The need for a [12] month "seasoning period" is less obvious.[284]

We agree with this commenter. The usual justification for the reporting issuer "seasoning period" is that this allows time for information about the newly minted reporting issuer to be disseminated and absorbed by the marketplace. It also allows time for the quality of the issuer's disclosure to improve before trading of exempt securities in the secondary market is allowed. With respect to the former, we note that SEDAR and other technological advances permit greater and faster access to information than ever before. Improvements in dissemination and accessibility of corporate disclosure have been dramatic since seasoning periods were first introduced. To the extent that quality of disclosure is the issue, it is unclear whether disclosure necessarily improves with the passage of time. Also, seasoning is not generally required to protect secondary market investors. For example, securities acquired under an initial public offering by prospectus can be immediately traded. We believe that if quality of disclosure is the real concern, it should be addressed directly.

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[283] The majority of commenters on this issue agreed with us. See comment letters of the BCSC, Torys LLP and Ontario Teachers' Pension Plan. Two commenters were concerned that it was too early to consider eliminating hold periods for reporting issuers. See comment letters of the TSX and Fasken Martineau DuMoulin LLP.

[284] Comment letter of Torys LLP on the Issues List, which noted that: "The specific hold periods were originally implemented for greater certainty as to when such a resale could occur but, based on experience, that objective has been outweighed by complexity and lack of cohesive purpose."

Recommendation:

We believe the need for seasoning periods in the case of reporting issuers should also be revisited with a view to their elimination if the reforms we contemplate in this Report are implemented.

D) NON-REPORTING ISSUERS

As will be evident from the above discussion, the considerations which support re-examining the need for hold periods and seasoning periods in the case of reporting issuers do not apply to non-reporting issuers. Companies that are not obliged, and have not committed, to provide the marketplace with a steady flow of continuous disclosure have not satisfied the condition prerequisite for their securities to be freely tradeable in the secondary market.

Recommendation:

Hold periods and seasoning periods should continue to apply to non-reporting issuers.

E) STRUCTURING TRANSACTIONS TO AVOID CONTROL BLOCK HOLD PERIODS

Some commenters on the Issues List questioned the practice whereby control block holders or other insiders appear to hold large positions in companies they founded or manage, and yet have disposed of their economic interests through the use of lending or derivative arrangements ("monetization structures") that do not trigger the insider reporting requirement.[285] Some of these transactions may be subject to insider trading requirements of the Act, but not all are subject to the insider reporting requirements of every province, depending upon their structure.[286] We think they should be, and address the need for insider reporting of these arrangements in Chapter 24.

It was also noted that these monetization structures permit control block holders to cash out at significant premiums over the price paid for privately placed securities[287] while circumventing applicable hold periods in the process. Control block holders should be prevented from structuring transactions to avoid applicable resale restrictions. To the extent that hold periods apply to securities held by control block parties, the Commission should address the conduct of those who, directly or indirectly, contravene these requirements.

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[285] See comment letters on the Issues List of the Ontario Teachers' Pension Plan and TSX Venture Exchange.

[286] Subsection 76(1) of the Act prohibits a person or company in a special relationship with a reporting issuer from purchasing or selling securities of the issuer while in possession of material undisclosed information about the issuer (the insider trading prohibition). Subsection 76(6) provides that the term "securities," when used in the context of the insider trading prohibition, includes a put, call or security the market price of which varies materially with the market price of the security of the issuer. This expanded definition of security may capture many monetization structures so that they cannot be entered into with an insider if the insider is in possession of material undisclosed information. On the other hand, the insider reporting requirements of the Act (section 107) require insiders to report trades in "securities" of the reporting issuer, but the definition of security is not expanded to include puts, calls or securities the market price of which varies materially with the market price of the security of the issuer.

[287] See comment letter on the Issues List of the IDA.

Recommendation:

We recommend that the Commission examine the practice whereby control block holders reduce applicable hold periods through the use of derivatives and other monetization structures.

12.4 Where Do We Go from Here?

While we believe that there is a continued need for "exempt financings," the restrictions imposed on these financings must be re-examined in the context of the evolution of the broader regulatory regime including:

a) enhanced continuous disclosure standards across Canada;
b) active continuous disclosure review programs by the Commission and other securities regulators across Canada;
c) statutory civil liability for continuous disclosure;
d) rigorous enforcement of continuous disclosure standards across Canada;
e) appropriate escrow requirements applicable to securities held by management and insiders of companies that go public; and
f) the move toward a more integrated disclosure system in Canada.

Exemptions for specific financings should continue to exist and should be harmonized across Canada. Securities acquired in reliance upon these exemptions should not be freely tradeable until the issuer becomes a reporting issuer. We question whether there is a continued need or justification for hold periods and seasoning periods for reporting issuers. In view of the complexity of the current system, the level of compliance with the maze of rules relating to resales of securities that are subject to hold periods and seasoning periods is suspect. We do not believe the inefficiencies and cost of compliance associated with the existing regime are justified when weighed against the benefits and we urge the Commission to undertake a focused review of this issue with a view to implementing meaningful reform.

DISCLOSURE STANDARDS

13.1 Material Fact, Material Change and Material Information

A) MATERIAL FACT VS. MATERIAL CHANGE IN THE CONTEXT OF CONTINUOUS DISCLOSURE

There is considerable confusion about the difference between a "material fact" and a "material change" and the purpose for which each of these terms is used in the Act. The distinction is perhaps best understood from the perspective of the evolution of an issuer's disclosure record.

As discussed previously, the prospectus is the base document for an issuer's disclosure. Both the preliminary and the final prospectus must contain full, true and plain disclosure of all *material facts* relating to the securities issued or proposed to be distributed. A "material fact" is defined as follows:

> "material fact", where used in relation to securities issued or proposed to be issued, means a fact that significantly affects, or would reasonably be expected to have a significant effect on, the market price or value of such securities.[288]

Any "fact" (specifically related to the issuer or not) will be a "material fact" if it significantly affects (or would reasonably be expected to have a significant effect on) the market price or value of the securities being issued.

After a preliminary prospectus has been filed, an issuer's disclosure record must be updated whenever there is a *material change*. A "material change" is defined as follows:

> "material change", where used in relation to the affairs of an issuer, means a change in the business, operations or capital of the issuer that would reasonably be expected to have a significant effect on the market price or value of any of the securities of the issuer and includes a decision to implement such a change made by the board of directors of the issuer or by senior management of the issuer who believe that confirmation of the decision by the board of directors is probable.[289]

The concept of "material change" drives the issuer's disclosure in three ways. First, if a material *adverse* change occurs after a preliminary prospectus has been filed, an amended preliminary prospectus must be filed. Other material changes would presumably be "good news" material changes and prospective purchasers would not be prejudiced by waiting for "full, true and plain disclosure of all material facts" in the final prospectus, which would include all material changes since the preliminary prospectus. Second, after the final prospectus has been filed, until the time that the offering is "out of distribution," the issuer must file an amended prospectus if any material change occurs. Finally, the continuous disclosure requirements in the Act require the issuer to issue a press release and file a material change report when any material change occurs.

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[288] The 2002 Amendments amend the definition of "material fact" to delete the *ex post facto* examination of the effects of the disclosure on the market price or the value of the security. The amendmenthas not yet been proclaimed in force. The change in definition is being made as a consequence of the Civil Liability Amendments discussed in section 11.6. The change to the definition was first recommended by the Allen Committee, which believed that it would be inappropriate to expose issuers to liability for materiality determinations after the fact.

[289] The Act, subsection 1.1(1).

How does a material change differ from a material fact? First there must be a "change" (as opposed to the existence of a "fact"). Second, the "change" must be in the business, operations or capital of the issuer (a material "fact" can be unrelated to an issuer's business, operations or capital as long as it has a significant effect on the market price or value of the securities being issued).[290] Issuers are not expected to continually interpret external political, economic, and social developments as they affect the affairs of the issuer, unless the external development will result in a change in the business, operations or capital of the issuer, in which case, timely disclosure of the change must be made.[291] However, reporting issuers would discuss external developments and the effect of such events on their companies in their interim and annual MD&A. Finally, the threshold for a "material change" is forward looking – the change in the business, operations or capital of the issuer must be one that *would reasonably be expected* to have a significant effect on the market price or value of any of the securities of the issuer.[292]

B) MATERIAL INFORMATION – ADDITIONAL DISCLOSURE REQUIREMENTS

Although the Act requires public disclosure only of material changes, the TSX and the Commission began to move issuers to an enhanced disclosure standard in the mid-1980s. At that time, the TSX adopted a requirement that listed companies disclose all "material information" (a concept that incorporates material changes, material facts and certain other information). In 1987, the CSA supported this enhanced disclosure standard by adopting National Policy Statement 40 Timely Disclosure (NP 40), recommending that issuers disclose all "material information." Material information is "information relating to the business and affairs of an issuer that results in or would reasonably be expected to result in a significant change in the market price or value of any of the issuer's securities."

The CSA rescinded NP 40 in connection with the adoption of National Policy 51-201 (NP 51-201) *Disclosure Standards* because much of the guidance in NP 40 was incorporated into NP 51-201. The CSA also determined that it could not, through a policy statement, change the test for triggering continuous disclosure obligations prescribed by statute. The Committee therefore considered whether the policy thrust of the TSX's timely disclosure policy and former

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[290] For example, it may be a material fact that an issuer has engaged financial advisers with respect to a recapitalization. However, until the issuer makes a decision to proceed, no material change has occurred.

[291] Speech of former Chairman, Peter Dey, (1983), 6 OSCB 2368.

[292] It should be noted, however, that the 2002 Amendments, when proclaimed in force, will amend the definition of "material fact" to delete the "ex post facto" examination of the effects of the disclosure on the market price or the value of the security.

NP 40 should form the basis of a legislative amendment requiring disclosure of all material information on a continuous disclosure basis.[293]

C) DISCLOSURE STANDARDS IN THE U.S.

We note that U.S. issuers do not have a specific statutory duty to make timely public disclosure of material changes or material information.[294] Periodic reporting requirements, such as Form 8-K, have instead been used to complement, rather than duplicate, the various U.S. stock exchange rules, which generally require disclosure of all material information.[295] In this regard, Ontario securities legislation already imposes a higher disclosure obligation than that of the U.S. by virtue of the requirement to make prompt disclosure of "material changes."[296]

D) SHOULD THE DISCLOSURE STANDARD IN ONTARIO BE CHANGED?

We received a number of submissions on whether reporting issuers should be required to disclose "material information" rather than "material changes" on an ongoing basis. Most were opposed to moving to this change.[297] Some noted that the current regulatory framework implicitly recognizes that it may be necessary for the proper functioning of the markets to require something less than full disclosure (such as in the context of incomplete negotiations). The commenters cautioned against a change that would disrupt this important policy consideration.

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[293] In 1995, the Allen Committee also considered whether the disclosure standard should be changed to "material information," the standard reflected at that time in NP 40. In its interim report, it concluded that the distinction between "material facts," "material information" and "material changes" causes some confusion for market participants and has contributedto a "lack of clarity in the rules." (See *Interim Report of The Toronto Stock Exchange Committee on Corporate Disclosure, Toward Improved Disclosure* (1996), 19 OSCB at page 83.) In this regard, the Allen Committee concluded that NP 40 and the TSE "got it right." However, the Allen Committee encountered significant resistance to this proposal and did not pursue this recommendation in its final report.

[294] Unlike Ontario laws, U.S. federal securities laws impose no general duty to disclose material developments as they occur, except where: (i) it is necessary to correct a previous untrue statement that has become materially misleading and on which the market is still relying (i.e., *"duty to correct"*); (ii) it is necessary to update forward-looking statements or projections on which the market continues to rely that were true when made, but later became materially false or misleading in the context of subsequent events (i.e., "*duty to update*"); or (iii) the issuer is in the process of buying or selling its own securities or wishes to facilitate such transactions by insiders (i.e., *"duty to disclose or abstain"*) (J. Robert Brown, *The Regulation of Corporate Disclosure*, 3rd ed., (Aspen Law & Business: New York) at pages 3-5). It should be noted, however, that the duty to update forward-looking statements or projections is a very unsettled area of U.S. federal securities law, characterized by considerable inconsistency in circuit court opinions as to whether such a duty exists.

[295] In June 2002, the SEC proposed that several new items or events be reported on Form 8-K in an effort to improve the quality, amount and timeliness of public disclosure of extraordinary corporate events. In addition, the SEC proposed that Form 8-K reports, also known as current reports, be filed within two business days instead of the current five to fifteen days.

[296] The *Sarbanes-Oxley Act of 2002* requires reporting companies to disclose "on a rapid and current basis" in plain English such information as the SEC may require concerning material changes in financial condition and operations, including "trend and qualitative information and graphic presentations."

[297] See comment letters of the Canadian Bankers Association, Royal Bank of Canada, Certified General Accounts of Ontario, Securities Subcommittee of the Ontario Bar Association, Davies Ward Phillips & Vineberg LLP, and Torys LLP. See also comment letters on the Issues List of Torys LLP, the IDA, Simon Romano, TSX Venture Exchange, and Peter McCarter of Aur Resources Inc., who were opposed to such a change.

For example, the IDA noted:

> The appropriate legal standard of materiality for the purposes of triggering a continuous disclosure obligation must strike a reasonable balance between the market's need to be informed on a timely basis of material developments concerning an issuer and the issuer's need for clarity as to the circumstances in which such disclosure must be legally made, particularly in light of the immediacy of the obligation. It is also essential to recognize that there are circumstances where an issuer (and its existing shareholders) legitimately has a need to keep material developments confidential. For these reasons, the IDA believes timely disclosure is best premised on "material changes" rather than "material facts" since in the latter case the issuer will typically require more time for thoughtful reflection as to the potential impact on share price or value of the development which has not yet progressed to the status of a change in the issuer's affairs. Premature disclosure of an intended financing or acquisition that may be considered a "material fact" is not beneficial for the secondary markets and can cause significant price interference for such transactions. For this reason, the IDA prefers the existing "material change" standard to a broader standard of "material developments."

The proposal to change the current trigger for making timely disclosure from a "material change" to "material information" has some appeal. First, by requiring prompt disclosure of "material information," more information would be available to the marketplace, which in turn would enable investors to make more informed investment decisions. Second, removing the distinction between a "fact," "change" and "information" would also help to bring more clarity to this difficult disclosure area. And third, mandating disclosure of material information under the Act would reduce reliance on exchange requirements that, in practice, have been difficult to enforce.[298] More specifically, if a violation occurs, an exchange can suspend trading in, or permanently delist, a company. Short of these relatively drastic sanctions, however, the exchanges have little ability to penalize violators for a failure to disclose "material information." Moreover, delisting is often viewed as an inappropriate remedy because it penalizes an issuer's securityholders by denying them the liquidity of an organized market rather than penalizing those directly responsible for the inadequate disclosure. We have tried to address this last concern in our recommendations dealing with enforcement. Our recommendation to expand the Act's enforcement mechanisms by giving the Commission the power to order compliance with exchange rules (rather than legislating a new disclosure requirement) will enhance the Commission's ability to deal with companies that breach exchange rules. At the same time, however, we strongly urge the exchanges to be more vigilant in policing and enforcing compliance by their listed companies with exchange timely disclosure requirements.

There are four reasons why we do not recommend that the disclosure requirement be moved to "material information." First, we believe that when the Civil Liability Amendments are proclaimed in force, issuers will have a strong incentive to take a more principled and less technical view of developments or matters that ought to be disclosed as "material changes," which should contribute to a more robust timely disclosure regime.

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[298] Each of the TSX and TSX Venture Exchange have policies in place which have, in effect, expanded the timely disclosure obligations of listed companies. The exchanges require that all listed companies make timely disclosure of all material information. See the TSX's *Policy Statement on Timely Disclosure and Related Guidelines* and TSX Venture Exchange's Policy 3.3 Timely Disclosure.

Second, as one commenter to the Committee noted, the "issue of when to disclose becomes much more problematic and difficult for issuers when material information or facts must be disclosed, such as merger negotiations and financial difficulty, etc., especially when such disclosure can and will be reviewed in hindsight particularly should statutory civil liability be instituted."[299] Phil Anisman's dissenting statement in the Allen Report also notes:

> Canadian securities legislation thus accommodates the fact that the materiality of corporate intentions and business plans develops with their progress and implementation. The legislation requires timely disclosure only after such plans have matured to the point where they are sufficiently firm that they may be characterized as a change in the issuer's business, operations or affairs, while recognizing that they may, if generally known, significantly affect share prices at an earlier stage and precluding those who are aware of them from using their knowledge to trade in the issuer's share before the change, and public disclosure, occurs.

Third, disclosure of all material information would impose a significant burden on issuers to continually monitor matters external to them for the purpose of informing investors.

Finally, if there are perceived gaps in information that is being disclosed by reporting companies on a continuous disclosure basis, the Commission has the necessary rulemaking authority to promulgate specific disclosure requirements similar to the SEC's Form 8-K approach noted above, and should be encouraged to do so where appropriate. Periodic reports, like the SEC's Form 8-K, should in our view be used to augment the existing framework of timely disclosure. In this regard, we note that one commenter was also strongly in favour of the Commission adopting an enhanced timely disclosure obligation for reporting issuers similar to the SEC's Form 8-K.[300] The commenter urged the Commission to study the SEC's Form 8-K requirements and in particular, the requirement that agreements relating to the reported disclosure be filed as a schedule to the public report. While not advocating a change to a "material information" timely disclosure standard, the commenter also suggested that the current definition of "material change" and the requirements relating to material change reports be re-examined. In particular, the commenter noted:

> Issuers generally provide little or no additional information in the material change report than was disclosed in the corresponding press release. The material change report should be revised to provide clearer instructions for the level of detail of disclosure requirement and contain specific requirements to annex as exhibits written agreements entered into in connection with the reported event.
>
> The definition of "material change" was introduced in the Act in 1978 as part of the integrated disclosure system reforms initiated in Ontario by the 1970 Merger Report. The standard for timely disclosure in Ontario has not changed since that time and it is submitted that it is now

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[299] See the comment letter on the Issues List of Peter McCarter.

[300] See comment letter of Fasken Martineau DuMoulin LLP.

> outdated and ineffective to serve investor interest in the current environment. ...[When] a "change" has been accepted to have occurred, the type of "change" requiring timely disclosure is limited and only applies with respect to a few narrow categories, namely a change "in the business, operations or capital" of the reporting issuer. There are other significant categories of matters or factors concerning a reporting issuer that are equally or more material to investors.
>
> It may be noted that the decision in Pezim v. British Columbia (Superintendent of Brokers) might well have been different, on the same facts, if decided under the definition of "material change" in the Act as opposed to the definition of "material change" in the *British Columbia Securities Act*. In the latter statute, "material change" is defined as a "change in the business, operations, assets or ownership of the issuer". As stated by Mr. Justice Iacobuccsi in Pezim for the Supreme Court of Canada ...:
>
> > Consequently, I am of the view... that the assay results constituted a change with respect to or in the companies' assets and is "material" for the purposes of the Act.
>
> It is open to reasonable debate whether the information resulting from the drilling program constituted a "change" in the "business" or "operations" of the company under the Act. Such a question of whether or not that information required public disclosure under the Act should never even be open to debate, however, because as a matter of public policy and principle, such discovery is clearly accepted, virtually unanimously, as a material piece of information for investors requiring timely public disclosure as soon as practicable after confirmation of the event.

We believe that the SEC's Form 8-K approach and the concerns raised by the commenter merit further study and urge the Commission to consider these issues.

Recommendations:

1. We recommend that the Act's timely disclosure provisions not be amended to require disclosure of "material information."

2. We recommend that the Commission study whether the current definition of "material change" and timely disclosure reporting obligations should be amended to encompass:

    - a broader scope of discloseable events;
    - itemized particular company-specific events requiring timely disclosure similar to the SEC's 8-K approach; and
    - a requirement that agreements relating to the reported disclosure be filed as a schedule to the public report.

13.2 What Is the Appropriate Standard for Materiality?

A) MARKET IMPACT VS. REASONABLE INVESTOR TEST

Under the Act, both "material change" and "material fact" are defined with reference to whether the change or fact "would reasonably be expected to have a significant effect on the market price or value of a security."[301] This "market impact" standard of materiality is common to all CSA jurisdictions other than Quebec.[302] In contrast, in the U.S. information is material if there is a substantial likelihood that a reasonable investor would consider it important in making an investment decision. To satisfy the U.S. materiality standard, there must be a substantial likelihood that a fact "would have been viewed by the reasonable investor as having significantly altered the "total mix" of information made available."[303] This "reasonable investor" test is not a statutory test, but has developed through case law.

In 1997, the CSA considered amending the definitions of "material fact" and "material change" by replacing the Canadian "market impact" test with the U.S. "reasonable investor" test.[304] The CSA received a number of comment letters, some of which were supportive. Some commenters raised a number of concerns, including that the proposed definitions raised too many issues of interpretation, that a single materiality standard was not viable and that such a change would introduce an unacceptable level of subjectivity and uncertainty.[305] The CSA ultimately decided not to pursue the proposed changes.

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[301] By way of background, it should be noted that the terms "material fact" and "material change" are applied in many contexts under the Act. The terms "material fact," "material change" and "misrepresentation" (itself defined by reference to "material fact") apply in connection with: (i) disclosure requirements and remedies, including required standards of disclosure in such documents as prospectuses, offering memoranda, bid circulars, proxy circulars and material change reports, and remedies and sanctions for failures to meet the required standards of disclosure; and (ii) insider trading prohibitions, in relation to both the standard of materiality and remedies and sanctions for contraventions.

[302] The insider trading and tipping prohibitions in Quebec refer to "privileged information," which is based on a reasonable investor standard of materiality. By contrast, for purposes of prospectus and timely disclosure, the Quebec Act uses a market impact test of materiality. In particular, section 13 of the Quebec Act provides that a prospectus must disclose all material facts likely to affect the value of the market price of the securities to be distributed. Similarly, the Quebec Act provides that "where a material change occurs that is likely to have a significant influence on the value or the market price of the securities of a reporting issuer and is not generally known, the reporting issuer shall immediately prepare and distribute a press release disclosing the substance of the change."

[303] *TSC Industries, Inc. v. Northway Inc.*, [1976] 426 U.S. 428, 449.

[304] In November 1997, certain members of the CSA published for comment proposed amended definitions of "material fact" and "material change" which would have introduced a single materiality standard for all purposes under securities legislation based on the U.S. reasonable investor test (the "Request for Comment"). The proposed amended definitions were published again in May 1998 as part of the proposed amendments to securities legislation which would create a statutory civil liability regime for continuous disclosure. See CSA Notice 53-302 Report of the CSA Proposal for a Statutory Civil Remedy for Investors in the Secondary Market and Response to the Proposed Change to the Definitions of "Material Fact" and "Material Change" (2000), 23 OSCB 7383.

[305] *Ibid.*

The comments we received on this issue reflect the continuing range of views. There are good arguments both to support preserving the status quo and to support a change in the materiality standard. Some proponents of the status quo argue that the current "market impact" test works reasonably well and is a more objective test than the reasonable investor test. Others note that, since U.S. courts tend to consider market impact when applying the reasonable investor test, a change in the definition for Canadian law purposes would not produce a significant difference in result. Still others argue that this would require market participants to adopt a different disclosure standard, while contemporaneously becoming subject, for the first time, to a regime that imposes civil liability for non-compliance with such a standard. Accordingly, they argue that the implementation of any proposed change to the materiality standard should be delayed for some period until Canadian capital markets have adjusted to the implementation of the new liability regime.

Advocates of changing the materiality trigger to conform to the U.S. reasonable investor test argue that the standard of "full, true and plain" disclosure applicable to prospectuses is effectively the reasonable investor standard, and "if we aim to promote credible capital markets, the same standard should be applied to trigger continuous disclosure and to its contents."[306] We note also that this standard has already been imported into Ontario securities law in the context of specific regulatory instruments.[307] Others argue that harmonizing Ontario (and ultimately Canadian) securities law with U.S. securities law will eliminate some of the complexity issuers currently face in fulfilling their disclosure obligations, particularly issuers whose securities are traded in both Canada and the U.S..[308] Also, some observers have noted that the market impact test may allow issuers to take too formulaic an approach in determining what is material.[309] As a result, in practice, the reasonable investor standard is often relied upon when advising issuers as to whether they have an obligation to disclose a particular change as a material change.[310]

Finally, some make the argument that there is really no difference between the Canadian "market impact" test and the U.S. "reasonable investor" test since a "reasonable investor" will only be concerned with whether a fact or change would affect the price or value of the security. This argument can be used to support a change to the Canadian test because it will in fact result in no practical change at all; it can also be used to support the status quo, since change in this case will not result in any meaningful difference in the disclosure standard.

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[306] Tory Tory DesLauriers & Binnington, *Canadian Securities Regulators Propose to Adopt Tougher U.S. Standards on Public Issuer Disclosure* (December 6, 1997).

[307] See, for example, Instruction 3 to Form 41-501F1 Information Required in a Prospectus.

[308] See, for example, the comment letter of Philip Anisman, on behalf of the TSX, to the CSA dated December 22, 1997.

[309] See comment letter of Davies Ward Phillips & Vineberg LLP.

[310] *Ibid.*

The Committee deliberated extensively on this matter. We acknowledge that compelling arguments have been made to support keeping the market impact test and to support replacing it with the reasonable investor test. Throughout this Report, we have emphasized the need for increased regulatory harmonization, except where specific policy objectives preclude it. We believe that requiring issuers to contemplate what would be important to an investor is the appropriate standard and therefore recommend that the definition be changed to be consistent with the U.S. "reasonable investor" test.

Recommendation:

We recommend that the existing materiality standard should be changed for all purposes under securities legislation to a reasonable investor standard which is consistent with the materiality standard in the U.S.

CHAPTER 14

SELECTIVE DISCLOSURE

14.1 Selective Disclosure

Selective disclosure has received considerable attention in the last several years. The concern is with material non-public information that is disclosed to one or more individuals or companies and not broadly to the investing public. Much of the discussion has focused on the SEC's Regulation FD, which became effective on October 23, 2000.[311] Regulation FD requires reporting companies to disclose material information through broad non-exclusionary public means rather than selectively to securities analysts and other market professionals.

Selective disclosure raises a number of issues. Most obvious is the unfairness resulting from some investors having material information before others and the opportunities that this creates for illegal insider trading. In adopting Regulation FD, the SEC also expressed the following concern:

> If [corporate managers] are permitted to treat material information as a commodity that can be parceled out selectively, they may delay general public disclosure so that they can selectively disclose the information to curry favor or bolster credibility with particular analysts or institutional investors. Moreover, if selective disclosure were to go unchecked, opportunities for analyst conflicts of interest would flourish. We are greatly concerned by reports indicating a trend toward less independent research and analysis as a basis for analysts' advice, and a correspondingly greater dependence by analysts on access to corporate insiders to provide guidance and "comfort" for their earnings forecasts. In this environment, analysts are likely to feel pressured to report favorably about particular issuers to avoid being "cut off" from access to the flow of non-public information through future analyst conference calls or other means of selective disclosure. This in turn raises concerns about the degree to which analysts may be pressured to shade their analysis in order to maintain their access to corporate management.

Prior to the adoption of Regulation FD, there was no express statutory prohibition against selective disclosure under U.S. securities laws. U.S. courts instead implied such a prohibition under the general anti-fraud provision, Rule 10b-5, in the 1934 Act. This approach led to uncertain results in establishing which type of selective disclosure was prohibited in the U.S.[312] Given the SEC's recognition that issuers retain control over the precise timing, audience and means for important corporate disclosure, it adopted Regulation FD as an issuer disclosure rule.

Canadian securities law, on the other hand, has a specific and comprehensive insider trading and tipping regime which prohibits, among other things, all selective disclosures except in the "necessary course of business."[313] However, notwithstanding the clear statutory prohibition on selective disclosure in Canada, Canadian issuers have not always complied with this prohibition. In 1995, the Allen Committee raised concerns about the practice of selective disclosure in private meetings between issuers, analysts and professional investors.

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[311] See Release Nos. 33-7881, 34-43154, IC-24599, File No. S7-31-99 Selective Disclosure and Insider Trading.

[312] See, for example, *Dirks v. SEC*, [1983] 463 U.S. 646, in which the U.S. Supreme Court stated that an analyst tippee would be subject to insider trading liability if the tipper breached a fiduciary duty to shareholders in disclosing material non-public information and the tippee knew or should have known of the breach. As articulated by the Supreme Court, breach of a fiduciary duty exists where the "insider" will benefit, directly or indirectly, from the disclosure. This benefit may be in the form of a pecuniary gain or reputational benefit that will translate into future earnings.

In 1999, the Commission conducted a random survey of the corporate disclosure practices of 400 public companies. The survey indicated that the extent and nature of corporate disclosure policies and practices of reporting issuers in Ontario was not at that time sufficient to reduce the potential for selective disclosure.[314]

In November 2001, the Analysts Standards Committee issued its final report, *Setting Analyst Standards: Recommendations for the Supervision and Practice of Canadian Securities Industry Analysts*. The Analysts Standards Committee was formed in late 1999 by the IDA, the TSX and TSX Venture Exchange "in response to concerns about the supervision of research analysts, the standards of practice and how analysts deal with potential conflict of interest situations."[315] The final report contains a number of recommendations aimed at improving the independence of research and ensuring the professional practice of securities industry analysts, including recommendations for dealing with the practice of selective disclosure. In particular, the Analysts Standards Committee recommended that:

- the Saucier Committee should consider, as part of the corporate governance responsibility of a company's board of directors, the need for the development and review of a communications policy that addresses how a company's management interacts with analysts and the public, and how the company avoids selective disclosure; and
- public companies include the media and investors in analyst meetings and conference calls, thereby avoiding the risk of selective disclosure.[316]

In July 2002, the CSA adopted a policy statement that discusses the Canadian legislative prohibitions against selective disclosure and sets out the CSA's views concerning the interpretation of these provisions.[317] The policy statement also highlights some "best disclosure" practices that companies can adopt to ensure that they comply with securities legislation.

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[313] In Ontario, see subsection 76(2) of the Act.

[314] For example, 71 per cent of the respondents did not have written corporate disclosure policies; 81 per cent of the respondents reported that they have one-on-one meetings with analysts; 98 per cent of the respondents reported that they typically comment in some form on draft analyst reports; and 27 per cent of the respondents indicated that they express a level of comfort on earnings projections. See Ontario Securities Commission Staff Notice 53-701 *Staff Report on Corporate Disclosure Survey* (2000), 23 OSCB 5098.

[315] TSX News Release, "Analyst Standards Committee Recommends Mandatory Disclosure," April 12, 2001 (http://www.tse.com/news/news_rel/news_523.html).

[316] *Setting Analysts Standards: Recommendations for the Supervision and Practice of Canadian Securities Industry Analysts* (October 2001 – Final Report) at pages 72 and 73, (http://tse.com/cgi-bin/uni_framset.cgi?content=news/news_rel/news_523.html).

[317] See National Policy Statement 51-201 *Disclosure Standards* (2002), 25 OSCB 4492.

We share the concerns expressed by the above-noted committees and securities regulators. While issuer selective disclosure may not be a new phenomenon, the effect of such selective disclosure is greater in today's more volatile, earnings-sensitive markets. This is particularly disturbing when one considers that advances in communications and information technologies have made it easier for companies to disseminate important information more broadly and quickly. We endorse the CSA approach. As previously indicated in our Draft Report, we continue to believe that guidance from the CSA in the form of a policy statement coupled with increased emphasis on enforcement in this area[318] should be adequate to change market behaviour.

All commenters on this issue agreed that there are sufficient rules in Canada prohibiting selective disclosure.[319] Several commenters encouraged the Committee, however, to give further consideration to recommending the creation of a 24-hour safe harbour for non-intentional selective disclosures like the safe harbour available under the SEC's Regulation FD.[320] In particular, one commenter stated:

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[318] See *In the Matter of Gary George* (1999), 22 OSCB 7171, where the Commission addressed in obiter the issue of a selective disclosure made by an issuer's chief executive officer to an analyst and the subsequent disclosure by the analyst to other members of his firm:

> It would appear that some corporate officers see the maintenance of good relations with analysts as being more important than ensuring the equality of material information among shareholders. The fact that it was thought [the analyst} was about to come out with a report as to [the issuer] which would overvalue its shares would in no way justify [the President] giving the information to [the analyst] rather than publicly disseminating it. If the information was material enough to cause [the analyst] to change his projections, it should have been publicly disseminated. In general, we view one-on-one discussions between an officer of a reporting issuer and an analyst as being fraught with difficulties.

In August 2001, the Commission approved a settlement agreement reached between Commission staff and Air Canada with respect to Air Canada's alleged disclosure of earnings information to analysts during the company's self-imposed "quiet period." In the *Excerpt from the Settlement Hearing Containing the Oral Reasons for Decision*, the Commission stated: "Communication by a corporation with analysts is not covered under some exception; so what is disclosed to analysts, if it is material and will significantly affect the market price, or reasonably may be expected to significantly affect the market price of the shares of the issuer, should not be selectively disclosed" ((2001), 24 OSCB 4899).

[319] See comment letters of the IDA, Ontario Teachers' Pension Plan, the TSX, Torys LLP, Fasken Martineau DuMoulin LLP, and Davies Ward Phillips & Vineberg LLP. See also the comment letters on the Issues List of Smith Lyons, the IDA, and The Canadian Bankers Association.

[320] See comment letters of Fasken Martineau DuMoulin LLP, Davies Ward Phillips & Vineberg LLP and the BCSC. Under Regulation FD, the timing of required public disclosure differs depending on whether the issuer has made an "intentional" or "unintentional" selective disclosure. For an "intentional" selective disclosure, the issuer is required to publicly disclose, in the manner required, the same information simultaneously with the "intentional" selective disclosure. The Regulation's definition of "intentional" requires that the individual making the disclosure must know (or be reckless in not knowing) that he or she would be communicating information that is both material and non-public. When an issuer makes a non-intentional disclosure of material non-public information which is subject to the Regulation, it is required to make public disclosure "promptly". For this purpose, "promptly" means "as soon as reasonably practicable," but in no event after the later of 24 hours or the commencement of the next day's trading on the NYSE, after a senior official of the issuer learns that there has been a non-intentional disclosure of information by the issuer or a person acting on behalf of the issuer that the senior official knows, or is reckless in not knowing, is both material and non-public.

> There is no safe harbour in provincial securities legislation for an unintentional selective disclosure. The absence of a safe harbour could weigh against the prompt dissemination of an unintentional selective disclosure, notwithstanding the CSA policy suggesting that this would be a mitigating factor in an enforcement proceeding. There is no justification for the different treatment of unintentional selective disclosures in Canada and the U.S.[321]

The proposing release for Regulation FD suggests that the SEC promulgated the 24-hour safe harbour in recognition that corporate officers may sometimes make mistakes without the intent to selectively disclose material non-public information.[322] When mistakes are made, absent intent or recklessness, the SEC did not believe that an issuer should be held responsible under Regulation FD for not having made simultaneous public disclosure. For example, a communication would not be "intentional" under Regulation FD if it was disclosed inadvertently or because the individual mistakenly (but not in reckless disregard of the truth) believed that the information had already been made public or was not material.

We believe that the SEC's 24-hour safe harbour helps to ensure fair treatment of companies and their spokespersons in attempting to comply with the spirit of the regulation. In particular, the 24-hour safe harbour provides companies with specific comfort that good-faith attempts to comply with the selective disclosure provisions, including difficult judgements about "materiality" that prove to be wrong in hindsight, will not subject a company or its officials to a violation of Regulation FD. We recognize that the CSA has in its policy statement attempted to provide companies with some degree of comfort in this area. We believe, however, that a policy statement approach on this issue does not go far enough as it does not have the force of law. We therefore believe that the CSA should introduce a safe harbour for "unintentional" selective disclosures along the lines of the safe harbour that exists in the U.S. under Regulation FD. In this regard, we recognize that it may be necessary for the CSA to modify the U.S. safe harbour so that it works within the framework of the existing Canadian prohibitions against selective disclosure.

Recommendations:

1. Except as noted below, we do not believe that legislative change is required in Ontario to address the issue of selective disclosure and we support the CSA's policy statement and an increased emphasis on enforcement in this area.

2. We recommend that the CSA introduce a 24-hour safe harbour for "unintentional" selective disclosures along the lines of the safe harbour that exists in the U.S. under Regulation FD.

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[321] See comment letter of Fasken Martineau DuMoulin LLP.

[322] See Proposing Release Nos. 33-7787, 34-42259, IC-24209, File No. S7-31-99 Selective Disclosure and Insider Trading.

FINANCIAL STATEMENT ISSUES

15.1 Financial Statement Disclosure

We believe that a number of improvements need to be made in the financial reporting requirements set out in the Act. These improvements are described below.

A) TIMING OF RELEASE OF FINANCIAL STATEMENTS

Reporting issuers must deliver quarterly financial statements to their shareholders (and file those statements with the Commission through SEDAR) no later than 60 days after the end of the quarter. They must deliver annual audited financial statements to their shareholders (and file those statements with the Commission through SEDAR) no later than 140 days after the end of the fiscal year.

In our view, the 60- and 140-day filing deadlines are out of date. The fact that issuers routinely release quarterly and year end financial information well in advance of the date on which their financial statements are filed and sent to shareholders supports this contention. Information technology advances have increased the speed at which financial information can be collected and analyzed.

In our Draft Report we recommended that the periods for filing annual financial statements be reduced to 90 days after the fiscal year end and that the time periods for filing interim financial statements be reduced to 45 days after the end of each quarter. Most commenters were supportive of this recommendation.[323] After the release of our Draft Report, the CSA released for comment National Instrument 51-102 *Continuous Disclosure Obligations*. The National Instrument proposes to reduce the deadline for filing annual financial statements from 140 days to 90 days after the year end for senior issuers and 120 days for all other issuers. It is also proposed that the deadline for filing interim financial statements will be reduced from 60 days to 45 days after the quarter end for senior issuers, and remain at 60 days for all other issuers. The National Instrument uses TSX non-exempt company criteria as the benchmark measure for a senior issuer.[324] We note that the time periods being proposed by the CSA for senior issuers are the time periods that have been existence in the U.S. for nearly 30 years. The SEC recently adopted rule amendments to further shorten these time periods for senior issuers to 60 and 35 days respectively.[325]

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[323] See comment letters of Certified General Accounts of Ontario, the Association for Investment Management and Research, Fasken Martineau DuMoulin LLP, Ontario Teachers' Pension Plan, the Canadian Institute of Chartered Accountants, PricewaterhouseCoopers LLP, Davies Ward Phillips & Vineberg LLP, Torys LLP, the Canadian Bankers Association, and Royal Bank of Canada.

[324] These criteria include having net tangible assets of at least $7.5 million, or in the case of oil and gas companies, proved developed reserves of at least $7.5 million.

We endorse the CSA's proposal to reduce the deadlines for filing annual and interim financial statements, including the different filing periods being proposed for junior issuers. We recognize that not all companies, particularly small and unseasoned companies, may have the infrastructure and resources necessary to prepare their reports on a shorter time frame without undue burden or expense. As noted in the Introduction, we believe that securities regulation in Canada must be sensitive to the nature of our capital markets and the participants that inhabit it, such as the large proportion of small-cap issuers that characterize our markets. This may require developing and applying different standards to different tiers of issuers. We do have concerns, however, about the TSX non-exempt company criteria chosen by the CSA to separate senior issuers from junior issuers. In our view, this benchmark is too complicated and difficult to use. We strongly encourage the CSA to consider a simpler formula that both market participants and investors can more easily understand. In this regard, we recommend that the CSA consider classifying senior issuers as those issuers whose securities are listed on the TSX and junior issuers as those issuers whose securities are listed on the TSX Venture Exchange.

We also recommend that in due course the CSA consider shortening even further the filing deadlines for annual and interim financial statements to 60 and 35 days respectively to parallel recent rule changes made by the SEC.

Finally, we note that we did receive one comment letter on our Draft Report that suggested that it would be difficult for large companies with international operations to comply with the reduced filing deadlines for annual and interim financial statements.[326] While we have some sympathy for the concerns raised by the commenter, we believe that such situations could be better addressed by the Commission on a case-by-case basis by granting, where appropriate, exemptive relief.

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[325] On September 5, 2002, the SEC adopted rule amendments to accelerate the filing of quarterly and annual reports under the 1934 Act by domestic reporting companies that have a public float of at least $75 million, that have been subject to the 1934 Act's reporting requirements for at least 12 calendar months and that previously have filed at least one annual report. The changes for these accelerated filers will be phased in over three years. The annual report deadline will remain 90 days for year one and change from 90 days to 75 days for year two and from 75 days to 60 days for year three and thereafter. The quarterly report deadline will remain 45 days for year one and change from 45 days to 40 days for year two and from 40 days to 35 days for year three and thereafter. (See Final Rule: Acceleration of Periodic Report Filing Dates and Disclosure Concerning Website Access to Reports Securities and Exchange Commission – Release Nos. 33-8128; 34-46464; FR-63; File No. S7-08-02).

[326] See comment letter of Power Corporation of Canada.

Recommendations:

1. We support the CSA's proposal to reduce the filing period for filing annual financial statements to 90 days after the fiscal year end for senior issuers, and 120 days for junior issuers. We also support the CSA's proposal to reduce the filing period for filing interim financial statements to 45 days after the quarter end for senior issuers, and to maintain the current 60-day deadline for junior issuers. We recommend, however, that the CSA reconsider whether to use the TSX non-exempt company criteria to separate senior issuers from junior issuers. Instead, we recommend that the CSA consider classifying senior issuers as those issuers whose securities are listed on the TSX and junior issuers as those issuers whose securities are listed on the TSX Venture Exchange.

2. We recommend that in due course the CSA consider shortening even further the filing deadlines for annual and interim financial statements to 60 and 35 days respectively to parallel recent rule changes made by the SEC.

B) AUDITOR REVIEW OF QUARTERLY FINANCIAL STATEMENTS

In Ontario, quarterly financial statements must be reviewed by the board of directors or audit committee.[327] This requirement was introduced in 2001 as a means of promoting the integrity of the financial statements and the role of the audit committee. If the board or audit committee does not play a role in the review of quarterly financial statements, then management is in control of the issuer's financial disclosure until year end, when the audit committee is required to review the annual financial statements before they are approved by the board of directors. At that point, if the audit committee has any issue with the accounting policies or judgements applied by management in preparing the financial statements, fourth-quarter adjustments can become an issue. Requiring the involvement of the audit committee at the end of each quarter reduces the potential for problems at the end of the year.

The Act does not require external auditor review of the quarterly financial statements, although the Commission recommends it.[328] The approach in the U.S. is the opposite. The 1934 Act requires auditor review of interim financial statements before they are filed with the SEC, but leaves it up to the issuer whether the board or audit committee should review the statements before they are filed. In our view it should be apparent to every board and audit committee that the auditors should review the quarterly financial statements. There is otherwise the potential for management and the audit committee (who approved the first three quarters) to be pitted against the auditors in the course of the audit and review of the annual statements. We recognize that additional costs will be associated with an auditor's review of the interim statements. However, in light of the importance of the integrity of financial statements, we believe that this additional cost should be accepted as a cost of being a public company.

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[327] OSC Rule 52-501 *Financial Statements*, subsections 2.2(6), (7).

[328] Companion Policy 52-501 to OSC Rule 52-201 *Financial Statements*, section 2.1.

We received a number of comment letters that were supportive of mandating external auditor review of reporting issuers' quarterly financial statements.[329] Some commenters suggested, however, that it might be appropriate to give junior issuers an exemption from this requirement as the costs associated with having external auditor review of interim financial statements would be disproportionately higher for smaller issuers.[330] We are sensitive to this concern and endorse in principle providing junior issuers with an exemption from this requirement. The nature and scope of the exemption should be determined by the regulators, taking into account the costs and benefits associated with the requirement, with particular attention being paid to the type of issuer and the stage of development of the issuer. We would also recommend, however, that any issuer subject to an exemption from the requirement should be required to disclose that its quarterly statements have not been reviewed by an external auditor.

Recommendation:

We recommend that Ontario securities legislation be amended to require that quarterly financial statements must be reviewed by the issuer's external auditor. We endorse in principle providing junior issuers with an exemption from this requirement. The nature and scope of the exemption should be determined by the Commission, taking into account the costs and benefits associated with the requirement with particular attention being paid to the type of issuer and the stage of development of the issuer. We would also recommend, however, that any issuer subject to an exemption from the requirement should be required to disclose that its quarterly statements have not been reviewed by an external auditor.

C) RELEASE OF FINANCIAL INFORMATION PRIOR TO BOARD APPROVAL

The release of financial information before interim and annual financial statements are approved by the board of directors or audit committee is also an issue of concern. Many issuers announce their earnings or other financial information soon after the end of a reporting period, but well before the financial statements themselves have been approved. We think that this is inconsistent with the requirement under Ontario securities law that such statements receive board (or audit committee) approval, and creates further potential for the audit committee to be backed into a corner by management when it comes to approving the statements.[331]

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[329] See comment letters of Fasken Martineau DuMoulin LLP, Ontario Teachers' Pension Plan, the Canadian Institute of Chartered Accountants, PricewaterhouseCoopers LLP, Canadian Investor Relations Institute, Davies Ward Phillips & Vineberg LLP, Torys LLP, and the Ontario New Democratic Party.

[330] See comment letters of Ontario Teachers' Pension Plan, the TSX Venture Exchange, and the TSX.

[331] We have no concerns, however, with a company press releasing selected financial information from a company's financial statements prior to receiving board approval of the full financial statement, provided that the board (or audit committee) has approved the selected financial information to be pre-released.

D) EARNINGS GUIDANCE

Quarterly earnings guidance from companies has become a common component of quarterly earnings announcements. Initially, earnings guidance was a tool used to improve transparency and reduce stock price volatility.[332] But with time, stocks have begun to move in response to earnings guidance. As a general matter, we have concerns about the practice of companies providing "earnings guidance" to the marketplace. We believe that the practice encourages short-term focus on the part of management and may also create incentives to manage earnings. In this regard we view the recent announcement by some companies, like Coca-Cola Co., that they will no longer be providing earnings guidance as a positive development and hope that the trend will continue.[333]

E) NON-GAAP FINANCIAL INFORMATION

Many issuers use non-GAAP numbers in communicating the results of operations to the public. The danger in non-GAAP numbers is that there is no common understanding of what they mean. There is therefore little basis for comparison of these numbers from one issuer to another. Moreover, they offer too much of an opportunity for an issuer to create a number that casts the financial results in a more positive light than would be the case if the numbers were derived from the financial statements. This practice was the subject of a CSA staff accounting notice early in 2002.[334] We suggest that the CSA monitor the use of non-GAAP or pro forma numbers in corporate disclosures to determine whether the CSA staff notice is causing companies to be more balanced in their financial disclosure. If not, the CSA should consider whether more aggressive regulatory intervention is warranted.[335]

F) FILING NEWS RELEASES

Reporting issuers issue news releases for a variety of reasons. As discussed above, they may be required by the Act to disclose a "material change" by way of a news release. The news release announcing the material change is appended to the material change report and filed on SEDAR. It is therefore readily accessible to anyone looking for the issuer's current disclosure record.

There are obviously a number of other reasons why issuers issue news releases. They may have "good news announcements" they wish to share with their investors or other stakeholders. They may simply wish to increase their profile or attract media attention. If the information does not constitute a "material change," an issuer may not file a copy of the news release on SEDAR.[336]

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[332] Ernst & Young, "Walking a Fine Line on Earnings Guidance" *CrossCurrents* (Fall 2002) (www.ey.com).

[333] "Leading the News: Coke to Abandon Profit Forecasts, Provide Data on Long-Term Goals" *Wall Street Journal* (December 16, 2002).

[334] CSA Staff Notice 52-303 *Non-GAAP Earnings Measures* (2002), 25 OSCB 112.

[335] In January 2003, the SEC adopted Regulation G, which applies whenever a company publicly discloses or releases material information that includes a non-GAAP financial measure. Regulation G requires a quantitative reconciliation (by schedule or other clearly understandable method) of the differences between the non-GAAP financial measure presented and the comparable financial measure or measures calculated and presented in accordance with GAAP (see Conditions for Use of Non-GAAP Financial Measures, SEC Release No. 33-8176).

In our Draft Report we considered the issue of whether any other type of news releases should be required to be filed on SEDAR. The issue that concerned us particularly was the release of earnings information in advance of the release of the financial statements. We expressed the view that news releases of this type form an integral part of an issuer's continuous disclosure record and such releases should be filed on SEDAR. Once the issuer's financial statements have been approved, as discussed above, then their release or the release of earnings information derived from them which has also been approved should be filed on SEDAR. This will ensure that this important disclosure is readily accessible to investors, to Commission staff conducting continuous disclosure reviews or investigating possible disclosure breaches, and to the marketplace generally. The majority of commenters were supportive of our recommendation in this regard.

In our Draft Report we also invited specific comment on whether there are any other definable categories of news releases that reporting issuers should be required to file on SEDAR. Our preliminary view was that it is likely unnecessary to require issuers to file all their news releases on SEDAR. We acknowledged that a requirement to file every news release on SEDAR could result in important information being buried. It could also lend legitimacy to promotional news releases. In response to our question, two commenters suggested that SEDAR should function as a central repository for all publicly available "material information" concerning each reporting issuer.[337] The commenters noted that companies often issue news releases that contain non-financial information that may be just as important to a reasonable investor in making an investment decision.

In response to the comments we received, we reconsidered our original concerns relating to the filing of all news releases on SEDAR. To the extent that issuers communicate with investors through news releases, we believe it is important that investors have a central location to access such information. We recommend that Ontario securities law should be amended to require issuers to file all their news releases on SEDAR. In implementing this recommendation, we would ask the CSA to consider, if possible, changes to SEDAR which will permit a filer to identify the type of news release filed. In particular, we would suggest that news releases be organized on SEDAR according to the following categories:

- news releases filed in connection with a material change report;

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[336] It may make a copy of the news release available on its website under "Investor Information," but it is under no obligation to do so.

[337] See comment letters of Davies Ward Phillips & Vineberg LLP and Fasken Martineau DuMoulin LLP. It should be emphasized, however, that the commenters were not advocating that reporting issuers should have an obligation to continuously report "material information."

- news releases containing financial information; and
- other.

We believe that such categorizations will make it easier for investors to search for news releases of interest to them on SEDAR. In implementing this recommendation we also recommend that the CSA build enough flexibility in SEDAR to permit a reporting issuer to recategorize a news release after it has been posted on SEDAR.[338]

Recommendation:

We recommend that Ontario securities law be amended to require that all news releases of reporting issuers must be filed on SEDAR.

G) THE GAAP EXEMPTION FOR BANKS AND INSURANCE COMPANIES

Although reporting issuers are required to prepare their financial statements in accordance with GAAP, the Regulation under the Act provides an exemption[339] from this requirement for banks listed in Schedule I or II to the *Bank Act* and life insurance companies licensed under the *Insurance Act* if their financial statements are "prepared in accordance with a statute incorporating, continuing or governing the bank or insurance company and any applicable GAAP."[340] Under federal legislation, OSFI has the authority to mandate accounting practices by regulated financial institutions. The effect of these sections is to allow OSFI to prescribe how Canadian GAAP should be applied and even to override GAAP.[341]

The GAAP exemption for banks and life insurance companies reflects the tension that sometimes exists between the objectives of securities regulation and prudential regulation. The focus of securities regulation is to ensure that capital markets and market participants operate in a transparent environment and that individuals have full information upon which to base their investment decisions. Prudential regulation, on the other hand, focuses on preserving the safety and soundness of financial institutions. This difference in focus has the potential to create conflicts. For example, in some cases prudential regulation may favour delayed disclosure or non-disclosure of certain events, whereas securities regulation would require full and prompt disclosure.

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[338] This would permit, for example, an issuer to recategorize a news release in relation to a material change after initially having posted the news release in the "Other" category.

[339] Subsection 2(3) of the Regulation. A similar exemption exists in the securities legislation of Alberta and Manitoba. The Quebec Act contains a similar exemption for banks only. Securities legislation of the remaining provinces and territories does not contain such an exemption.

[340] We understand that this exemption was originally adopted when banks, life insurance companies and property and casualty insurance companies were not fully included in the scope of the CICA Handbook. Over time, however, these institutions were brought fully within the scope of the Handbook. More specifically, the exemptions relating to property and casualty insurance companies, life insurance companies and banks were removed from the Handbook in September 1986, December 1987, and August 1992, respectively.

[341] See, for example, subsection 308(4) of the *Bank Act*, S.C. 1991, c. 46.

Amendments to the *Bank Act*, contained in the FCAC Act, give OSFI the same power to override GAAP for bank holding companies.[342] This power appears to go beyond the existing override provision in securities legislation and raises additional implications as a result. Whereas existing regulations to the Act only contain special provisions for issuers incorporated under the *Bank Act* and the *Insurance Act*, under the amendments to the *Bank Act* it appears that alternative financial statements may be prepared by holding companies that are reporting issuers but are not incorporated under the *Bank Act*.

While we appreciate the different focus of securities and financial institution regulation, we nonetheless have concerns about the current GAAP exemption available to banks and insurance companies under the Act and any potential extension of the GAAP override in the Act by virtue of the FCAC Act. We believe that disclosure is an important part of any regulatory regime. Disclosure requirements provide information on which investors can base their choices. We further believe that good accounting standards are a necessary precondition for sound market regulation and can help to stabilize market expectations. We note that the current GAAP exemption makes it difficult for Commission staff to undertake disclosure reviews of such institutions. Moreover, we note that the circumstances in which OSFI has exercised an override of GAAP are company specific, which can create arbitrary differences that distort comparability of reported results both among financial institutions and with other entities. For example, we understand that this statutory power has resulted in some banks, acting under a directive from OSFI, applying accounting treatments that are contrary to Canadian GAAP with respect to increases made to their loan loss provisions. In each case, OSFI permitted the bank in question to depart from GAAP by taking a charge for an increase in loan loss provisions through retained earnings rather than through the income statement. In at least one of these cases, the absolute amount of the loan loss provision after the increase was in excess of the amount permitted under GAAP. Given the choice between non-GAAP and GAAP reporting, the Committee ultimately favours transparency and the use of GAAP.

There is no GAAP exemption available to banks and insurance companies in the U.S.. The SEC requires GAAP financial statements from all of its reporting issuers. U.S. banking and insurance regulators can prescribe accounting methods to be applied in special purpose filings with them, but to the extent those methods depart from GAAP, they would be unacceptable for purposes of filings with the SEC.

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[342] See section 183 of the *FCAC Act*, which amends subsections 840(4) and 855(2) in Part XV Bank Holding Companies Division 6 of the *Bank Act*.

We prefer the approach adopted in the U.S., for the reasons set out above. In our Draft Report we did, however, set out an alternative approach. The alternative approach would permit the GAAP override for prudential purposes, where the solvency of the institution or the financial services system would otherwise be placed at risk. This alternative was based on OSFI's role as a prudential regulator and the belief that if it is to have any override powers with respect to securities legislation, they should only be exercisable in circumstances where there is demonstrable prudential concern. In this regard we invited comment on whether the GAAP override should be eliminated, as we preferred, or modified so as to be exercisable only where there is demonstrable prudential concern. The vast majority of commenters supported the elimination of the GAAP override.[343] In this regard, two commenters also noted that it is not necessary to override GAAP, because financial institution regulators can obtain the additional or adjusted financial information they need to make decisions on capital adequacy by requiring separate reports, if necessary.[344]

In June 2002, the CSA released proposed National Instrument 51-102 *Continuous Disclosure Obligations*. NI 51-102 proposes to, among other things, remove the GAAP exemption for banks and insurance companies in Ontario and all other CSA jurisdictions that currently have a similar exemption. We believe for the reasons noted above that the current GAAP override is far too broad and we therefore endorse the proposal under proposed NI 51-102 to eliminate the override.

Recommendation:

We recommend that the GAAP exemption available to banks and insurance companies in subsection 2(3) of the Regulation to the Act be removed.

15.2 Auditor Independence

In November 2000, the SEC adopted extensive amendments to its rules regarding auditor independence and new disclosure requirements aimed at:

- fostering high quality audits by minimizing the external factors that will influence an auditor's judgement; and
- promoting investor confidence in the financial statements of public companies.[345]

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[343] See comment letters of the Association for Investment Management and Research, Fasken Martineau DuMoulin LLP, Ontario Teachers' Pension Plan, the Canadian Institute of Chartered Accountants, the Canadian Bankers Association, the Nova Scotia Securities Commission, Royal Bank of Canada, and Torys LLP.

[344] See comment letters of Fasken Martineau DuMoulin LLP and the Canadian Institute of Chartered Accountants.

[345] See Final Rule, Revision of the Commission's Auditor Independence Requirements, Release Nos. 33-7919; 34-43602; 35-27279; IC-24744; IA-1911; FR-56; File No. S7-13-00. The rules became effective February 5, 2001, with transition periods for various types of transactions and relationships.

The new rules essentially provide that an accountant is not independent if he or she cannot exercise "objective and impartial judgement" or if a reasonable investor would conclude that an accountant cannot exercise objective and impartial judgement. This determination is based on the circumstances of the particular case, but the SEC also provided specific rules on some common situations that raise independence issues. In particular, the rules identified particular services, relationships or interests that the SEC regards as incompatible with independence.[346] The SEC rules further require companies to make certain disclosures in their proxy statements regarding relationships between a company and its auditors, including the fees paid to the independent auditor for audit and non-audit services.[347] More recently, the SEC adopted further amendments to its auditor independence rules in response to the *Sarbanes-Oxley Act of 2002*.[348]

The November 2000 SEC rules on auditor independence generated significant debate, particularly with respect to the issue of whether auditors should be permitted to provide non-audit services to their audit clients. Proponents of the rules argued that accounting firms that provide non-audit services to their audit clients aren't truly "independent" because non-audit work creates an incentive for auditors "to go easy on their clients," either to win more contracts or to prove that the advice of their colleagues was appropriate. Detractors, on the other hand, expressed concern that the rulemaking initiative would hurt businesses and that audits actually improve when firms perform auditing and non-auditing functions because it gives them a more comprehensive picture of a company's financial health. They also argue that the professional integrity of auditors creates an effective barrier to conflicts of interest.

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[346] These rules were revised in January 2003 in response to the *Sarbanes-Oxley Act*. The revised rules identify nine non-audit service functions that may not be performed by independent auditors for public company audit clients, including (i) bookkeeping or other services related to the accounting records or financial statements of the audit client; (ii) financial information systems design and implementation; (iii) appraisal or valuation services, fairness opinions, or contribution-in-kind reports; (iv) actuarial services; (v) internal audit outsourcing services; (vi) management functions or human resources; (vii) broker or dealer, investment adviser, or investment banking services; (viii) legal services; and (ix) expert services unrelated to the audit.

[347] These proxy disclosure rules were revised in January 2003 in response to the *Sarbanes-Oxley Act*. The new SEC rules provide new "buckets" for the disclosure of fees paid to the auditor. In particular, issuers must disclose in their annual reports fees paid to the independent accountant for (i) audit services, (ii) audit-related services, (iii) tax services, and (iv) other services. Additionally, the disclosure must include the audit committee's policies and procedures for pre-approval of services by the independent accountant as well as the percentage of fees paid subject to specified de minimis exceptions.

[348] See SEC rule: Strengthening the Commission's Requirements Regarding Auditor Independence, Release Nos. 33-8183; 34-47265; 35-27642. The new rules address issues such as: (i) required rotation of "audit engagement team" members, (ii) audit committee pre-approval of audit and non-audit services, (iii) prohibitions on compensation of audit team partners based on non-audit services, (iv) disclosure of critical accounting policies, and (v) prohibitions on employment of audit engagement team members by client. Under the new rules, accountants may continue to be allowed to provide tax compliance, tax planning and tax advice to audit clients, subject to audit committee pre-approval.

On September 5, 2002, the Public Interest and Integrity Committee of the CICA (PIIC) released a new draft independence standard to apply to Canadian auditors and other assurance providers.[349] The exposure draft is based on the principles-based framework for independence adopted by IFAC, the accounting profession's international body, in January 2002[350] and incorporates the rigour of pre-Sarbanes-Oxley SEC requirements for auditors of listed entities.[351] The public comment period closed October 31, 2002. The PIIC has also undertaken to consider changing the proposed Canadian independence standards to reflect the more recent SEC rules in response to Sarbanes-Oxley.[352] Prior to the PIIC's proposed independence standard initiative, Canadian standards did not contain specific prohibitions on the scope of services that auditors could perform for their audit clients.

We have been following with interest the various auditor independence rulemaking initiatives and the new spotlight that has emerged on auditor independence in the wake of recent corporate failures in the U.S. (such as Enron and WorldCom). The last year has seen Canada make great strides in developing substantive auditor independence standards. We believe that auditors play a critical role in promoting investor confidence in the integrity and reliability of financial disclosure. In an era when companies face extreme pressure to report ever-increasing profits, and the markets severely punish those who don't meet expectations, auditor independence is vital. We therefore strongly encourage the PIIC to attach a high priority to completing its auditor independence initiative. We also encourage the Commission to continue to proactively monitor ongoing developments in this area so that Canada does not fall behind international standards. The external auditing function is the critical foundation upon which our financial disclosure system rests.

In our Draft Report we had recommended that the Commission adopt amendments to its proxy disclosure rules similar to those already adopted in the U.S., requiring companies to disclose the amounts they pay to their auditors, both for auditing services and non-auditing services. We noted that the SEC believed that such disclosure rules would ultimately allow investors to evaluate for themselves whether the proportion of fees for audit and non-audit services raise concerns about the auditor's independence. We expressed support for the SEC's position on the basis that sunlight is the best disinfectant. At the time, Canada was lagging U.S. initiatives in the area of auditor independence such that disclosure, at a minimum, would have plugged at least part of the emerging gap and focused some attention on the area. In light of the considerable progress that has recently been made in Canada to develop substantive independence standards, however, we believe that the urgency behind implementing changes to proxy disclosure has lessened. While we continue to believe that disclosure rules in this area are important and should be adopted, we would recommend that the Commission consider implementing any disclosure rules in conjunction with, and in the context of, the PIIC's proposed independence standards and the recent SEC proxy disclosure rule changes. In this regard, we note that most commenters were supportive of implementing disclosure rules in Canada.[353] One commenter was of the view, however, that the U.S. proxy rules are flawed in how they categorize audit and non-audit services.[354] We would encourage the Commission to consider such concerns in promulgating any rule proposals in this area.

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[349] The Public Interest and Integrity Committee of the CICA. Exposure Draft Independence Standards (www.cica.ca).

[350] See http://www.ifac.org. The new IFAC code emphasizes that independence is a "state of mind that permits the provision of an opinion without being affected by influences that compromise professional judgement, allowing an individual to act with integrity, and exercise objectivity and professional scepticism."

[351] The PIIC's proposals would either prohibit or place strict limits on auditors performing a wide range of non-audit services for listed entities for which they are the auditor. The non-audit services include: appraisal or valuation services, or fairness opinions; management or human resources functions; investment dealer, adviser or investment banking services; legal services and expert services unrelated to the audit; bookkeeping services; design and implementation of financial information systems; actuarial services; and internal audits.

[352] See letter dated September 23, 2002 to David Brown from Donald G. Wray, Chair, Public Interest and Integrity Committee (www.osc.gov.on.ca/en/HotTopics/prom_inv_conf.html).

Recommendations:

1. We urge the Commission and the PIIC to adopt auditor independence standards on a priority basis, to proactively monitor ongoing U.S. developments relating to auditor independence and to consider what further reforms are necessary to ensure that Canada does not fall behind international standards.

2. We recommend that the Commission adopt amendments to proxy disclosure rules to require public companies to disclose in their proxy statements their expenditures for both audit and non-audit services. Amendments to proxy disclosure rules should be undertaken once the PIIC has finalized its proposed independence standards and should take into account those standards as well as recent proposed SEC rule changes for auditor independence.

15.3 Investor Reliance on Audited Financial Statements

Securities law requires all reporting companies to have their financial statements audited on an annual basis. In this regard, auditors are entrusted with an important public interest mandate: to examine objectively and comment on the fairness of the financial statements of reporting companies.[355] The integrity of our capital markets rests, in part, on a belief that this external audit function is objective and credible.

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[353] See comment letters of the Certified General Accountants of Ontario, the Association for Investment Management and Research, Fasken Martineau DuMoulin LLP, Ontario Teachers' Pension Plan, Torys LLP, the Canadian Institute of Chartered Accountants, and the Canadian Bankers Association.

[354] For example, the commenter noted that when a company prepares and files a prospectus, the company's auditor is required to perform substantial work in order to be able to among other things, file comfort and consent letters with the Commission. Such work is nonetheless characterized as a "consulting" service under U.S. proxy disclosure rules. See comment letter of PricewaterhouseCoopers LLP.

The courts have called into question the extent to which the public is entitled to rely on audited financial statements. In *Hercules Management Ltd.* v. *Ernst & Young*[356] the Supreme Court of Canada held that auditors owed no duty of care to shareholders with respect to their personal investment decisions.[357] We believe that the *Hercules* decision underscores the importance of the CSA's Civil Liability Amendments discussed previously in Chapter 11. Notwithstanding the *Hercules* decision, the Civil Liability Amendments will help to enshrine that auditors are held accountable to investors who place reliance on audit reports in making their investment decisions.

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[355] *Protecting the Public Interest: The Role of the Chartered Accountancy Profession*, prepared for the CICA by Kroll Associates (2001) at page 2 (http://www.cica.ca/cica/cicawebsite.nsf).

[356] [1997] 2 S.C.R. 165, where shareholders brought an action against a firm of accountants alleging that audits of the company's financial statements had been negligently prepared and, as a result, the shareholders had incurred investment losses.

[357] The court concluded that "to come to the opposite conclusion … would be to expose auditors to the possibility of indeterminate liability, since such a finding would imply that auditors owe a duty of care to any known class of potential plaintiffs regardless of the purpose to which they put the auditor's reports."

CORPORATE GOVERNANCE AND ACCOUNTABILITY OF PUBLIC COMPANIES

16.1 Certification

In August 2002, under the direction of the *Sarbanes-Oxley Act*, the SEC adopted final rules imposing obligations relating to certification of SEC filings on both CEOs and CFOs.[358] The new rules require CEOs and CFOs to certify the financial and other information contained in the company's quarterly and annual reports. The rules also require issuers to establish, maintain and regularly evaluate the effectiveness of disclosure controls and procedures designed to ensure that information required in reports under the 1934 Act is recorded, processed, summarized and reported on a timely basis. Specific disclosure regarding the evaluation of a company's disclosure controls and procedures, as well as its internal controls, is also required in a company's annual and quarterly reports.[359]

These rules effectively require CEO and CFO involvement with, and accountability for, their company's public disclosure. Following recent corporate failures in which senior officers testified that they delegated all responsibility for financial and other disclosure to management, U.S. Congress and the SEC have made it clear that they view such abdication to be inappropriate. In particular, the SEC noted:

> We believe that all members of a company's senior management, including members of the company's board of directors, should accept and acknowledge an active role in the disclosure that their company makes in its quarterly and annual reports and reinforce their accountability for the accuracy and completeness of this disclosure. We believe that any senior corporate official who considers his or her personal involvement in determining the disclosure to be presented in quarterly or annual reports to be an "administrative burden", rather than an important and paramount duty, seriously misapprehends his or her responsibility to security holders. …
>
> We believe that expressly requiring a company's principal executive officer and principal financial officer to certify that they have conducted this kind of review of the company's periodic reports would cause these officials to review more carefully the disclosure in their companies' quarterly and annual reports and to participate more extensively in the preparation of these reports. We expect that the quality and transparency of this disclosure would improve as a result of this type of mandated review.[360]

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[358] Certification of Disclosure in Companies' Quarterly and Annual Reports, SEC Release Nos. 33-8124, 34-46427.

[359] Section 13(2)(b) of the 1934 Act contains a long-standing provision requiring companies to devise and maintain internal controls.

[360] Proposing Release for Certification of Disclosure in Companies' Quarterly and Annual Reports, SEC Release No. 34-46079.

In response to our Draft Report, one commenter urged the Committee to recommend that the Commission pursue similar certification requirements. The commenter said:

> We strongly urge the Committee and the Commission to review SEC Release No. 34-46300 and section 302 of Sarbanes-Oxley Act of 2002 and to recommend that an analogous filing certification procedure be adopted by the Commission and other Canadian securities regulatory authorities for the benefit of investors in Canada. Notwithstanding that an appropriate civil liability scheme may ultimately be introduced across the country that assures adequate private civil law remedies to investors in the secondary markets who rely, or are deemed to rely, on misrepresentations contained in documents filed by reporting issuers, we believe that securities regulators should be directly responsible for enforcement of the accuracy and comp leteness of filed documents of reporting issuers through an analogous certification requirement to be adopted in Canada. It would be incongruous that a Canadian reporting issuer should certify its periodic disclosure reports to the SEC but not to the Commission.
>
> We recommend that the certification requirement for filed periodic reports under the Act be pursued by the Commission on its own in the event that the members of the CSA are not able to reach agreement.[361]

In connection with the ongoing debate relating to what corporate governance reforms Canada should adopt in response to recent U.S. initiatives, several observers, including the TSX and the Canadian Council of Chief Executives, have also indicated their support for the adoption of similar certification requirements in Canada.[362] The Canadian Council of Chief Executives states:

> In the past, we always have signed off on the accuracy of our companies' financial statements. We acknowledge, however, that the U.S. Sarbanes-Oxley Act has raised the bar in this respect. Even though this legislation may not apply to all Canadian companies, we believe that as Canadian chief executives, we should be prepared to offer a comparable certification of our annual and quarterly reports.[363]

After the release of our Draft Report, the Government of Ontario passed the 2002 Amendments that give the Commission rulemaking authority to address all aspects of the certification regime adopted by the SEC. We agree with the policy rationale underlying the SEC's certification initiative and share the views expressed above by the numerous commenters who support certification in Canada. In this regard, we endorse the legislative amendments made by the Government of Ontario and urge it to proclaim the rulemaking amendments in force on a timely basis to permit the Commission to embark on rulemaking in this area.

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[361] See comment letter of Fasken Martineau DuMoulin LLP.

[362] Letter to David Brown from Barbara Stymiest dated September 17, 2002 relating to U.S. corporate governance reforms (www.osc.gov.on.c./en/HotTopics) and "Governance, Values and Competitiveness – A Commitment to Leadership," A Statement of the Canadian Council of Chief Executives (September 2002).

[363] "Governance, Values and Competitiveness – A Commitment to Leadership," A Statement of the Canadian Council of Chief Executives (September 2002) at page 13.

Recommendation:

We endorse the 2002 Amendments that, when proclaimed in force, will give the Commission rulemaking authority to address all aspects of the certification regime recently adopted by the SEC. In this regard, we urge the Government of Ontario to proclaim the rulemaking amendments in force on a timely basis to permit the Commission to embark on rulemaking in this area.

16.2 Audit Committees

Most (although not all) Canadian corporate statutes require public companies to have an audit committee composed of at least three directors (at least two of whom must be outside directors).[364] The audit committee's statutory mandate is to review the issuer's annual audited financial statements before they are approved by the issuer's board of directors.

Although the statutory provisions relating to audit committees have changed very little since they were first introduced, best practices have established higher standards in terms of audit committee composition as well as broader mandates for audit committees. The CSA released a Notice on Audit Committees in 1990, responding to questions raised by issuers about the roles and responsibilities of audit committees.[365] Building on some of the recommendations in the CSA Notice, the TSX issued the TSX Guidelines for Effective Corporate Governance in 1995.[366] The TSX Guidelines recommend that an audit committee be composed only of outside directors and that the audit committee have a written mandate, direct communication channels with inside and outside auditors, and oversight responsibility with respect to management reporting on internal controls.

Recent developments in the U.S. have refocused attention in Canada on the importance of effective audit committees for the integrity of the financial reporting system. In September 1998, in response to growing concerns about reporting issuers misapplying U.S. GAAP in order to manage earnings expectations, former SEC Chairman Arthur Levitt launched an initiative aimed at improving the credibility and transparency of financial disclosure.[367] At the request of the SEC, the NYSE and NASD sponsored the Blue Ribbon Committee. In February 1999, the Blue Ribbon Committee released its report containing 10 recommendations aimed at strengthening the role of corporate audit committees in overseeing the financial reporting process. The specifics of the Blue Ribbon Committee's recommendations on audit committees dealt with the composition and mandate of the audit committee, particularly the processes by which the audit committee could enhance the independence of outside auditors. The Blue Ribbon Committee's recommendations were adopted, with some modification, by the SEC, the NYSE, the NASDAQ, the American Stock Exchange and the accounting profession.

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[364] Audit committees are not required under the corporate statutes of Nova Scotia, Prince Edward Island or New Brunswick.

[365] See CSA Notice 52-301 *Audit Committees* (October 19, 1990). We have found that there is comparatively little in subsequent literature (including the U.S. Blue Ribbon Commission Report discussed below) that was not covered in the CSA Notice on Audit Committees, other than the financial literacy of members of the audit committee.

[366] Section 474 TSX Company Manual. The TSX Guidelines are based on the recommendations of the Dey Committee. The Dey Report proposed a number of practices that companies should follow in order to improve corporate governance.

[367] See SEC Press Release, "NYSE Chair Richard Grasso, NASD Chair Frank Zarb, and Blue Ribbon Panel Co-Chairs Ira Millstein and John Whitehead Announce 'Ten-Point Plan' to Improve Oversight of Financial Reporting Process" at http://www.sec.gov/news/press/pressarchive/1999/99-14.txt.

In July 2000, the TSX, TSX Venture Exchange and the CICA sponsored the Saucier Committee. The terms of reference of the Saucier Committee asked it to respond to the new U.S. requirements adopted as a result of the Blue Ribbon Committee Report. The Saucier Report was released in November 2001 and recommended that the TSX Guidelines be amended in a number of ways to bring them into line with then-current U.S. requirements. With respect to audit committees, the Saucier Committee recommended that:

- audit committees should be composed exclusively of outside, "unrelated" directors (with some flexibility for TSX Venture Exchange Tier 2 companies that have small boards);
- all members of the audit committee should be financially literate, as determined by the board, with at least one member having accounting or related financial expertise; and
- the audit committee should: (i) adopt a written mandate, approved by the board, setting out its responsibilities, specifically with respect to its relationship with external and internal auditors, its oversight of internal controls and disclosure of financial and related information; (ii) disclose the mandate to the shareholders; and (iii) conduct a regular assessment of the committee's effectiveness.[368]

On April 26, 2002, the TSX proposed changes to its guidelines for effective corporate governance in response to the Saucier Committee's recommendations.

Since the release of the proposed changes to the TSX Guidelines, a number of significant developments have affected the role of the audit committee in the post-Enron environment:

- The U.S. *Sarbanes-Oxley Act of 2002* was passed and in effect vests audit committees of listed U.S. companies with sole responsibility for the appointment, compensation and oversight of any registered public accounting firm employed to perform audit services. Also, the *Sarbanes-Oxley Act* requires audit committees to be composed of solely independent, outside directors.[369]

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[368] The Saucier Report at page 29.

[369] In January 2003, in response to the *Sarbanes-Oxley Act*, the SEC proposed rules that will direct the national securities exchanges and national securities associations to prohibit the listing of any security of an issuer that is not in compliance with the audit committee requirements established by the *Sarbanes-Oxley Act* (see Proposed Rule: Standards Relating to Listed Company Audit Committees, SEC Release No. 33-8173; 34-47137).

- On July 24 and August 16, 2002, NASDAQ and the NYSE respectively submitted to the SEC new rules which, if approved by the SEC, would impose heightened corporate governance standards for listed companies, including
  - requiring audit committees to be composed of solely independent directors;
  - granting audit committees sole authority to hire and fire independent auditors;
  - requiring at least one member of the audit committee to be a "financial expert"; and
  - requiring audit committees to have a formal charter.

On August 15, 2002, the Commission wrote to the TSX asking that it re-examine its corporate governance guidelines and consider new measures to take into account recent U.S. developments. On September 18, 2002, the TSX responded to the Commission's letter by outlining proposed changes to its guidelines. While recommending that TSX-listed companies have fully independent audit committees, the TSX was not prepared to enshrine this as a mandatory rule. Instead, the rules will require that all issuers listed on the TSX have an audit committee with at least two independent committee members. Audit committees will also be required to have a charter setting out their roles and responsibilities. Beyond these two requirements, however, the TSX was opposed to implementing rules that would harmonize further with recent U.S. corporate governance reforms.

The TSX's response to the Commission has sparked a public debate in Canada about the appropriateness of instituting rules governing corporate governance versus maintaining a system based on voluntary guidelines and disclosure. Historically, there has been a strong preference in Canada not to legislate corporate governance practices beyond what is currently provided in the corporate statutes. The prevailing view has been that best practice guidelines, coupled with disclosure requirements, would drive most issuers toward best practices that were most appropriate for them. Some market participants and regulators have also raised concerns about the impact of corporate governance rules on small-cap issuers, which have smaller boards and fewer resources. Others have suggested that the number of Canadian public companies with a controlling shareholder calls out for a more flexible approach in Canada than in the U.S.

In light of the importance of the financial reporting process to the integrity of an issuer's financial statements and the regulatory force of audit committee standards in the U.S., we believe that it is appropriate today to seek to establish common standards and enforce compliance with these standards. As we mentioned at the outset, the requirement for audit committees had its genesis in corporate law statutes. However, we believe that reporting issuers should have audit committees that operate to common standards. Accordingly, in our Draft Report we recommended legislative amendments that would provide the Commission with rulemaking authority relating to the functioning and responsibilities of audit committees. In December 2002, the Government of Ontario passed legislation that gave effect to our recommendation.[370] We strongly endorse this amendment and note that many of our commenters were also supportive of our recommendation.[371] Moreover, we think it is important that reporting issuers in all Canadian jurisdictions hold their audit committees to consistent standards. Accordingly, we encourage the other CSA jurisdictions to provide their Commissions with similar powers and for the CSA to work together on an expedited basis to establish standards for audit committees that will place Canadian audit committee standards in the "best of class" internationally. In this regard, we also encourage the CSA to be sensitive to the needs and resources of small-cap issuers in crafting any rule proposals. In particular, we believe that it might be necessary to institute a two-tier system of regulation in this area.

Recommendation:

We endorse the recent amendment to the Act that, when proclaimed in force, will give the Commission rulemaking authority to prescribe requirements relating to the functioning and responsibilities of audit committees of reporting issuers. We encourage other CSA jurisdictions to give their commissions similar powers, and we urge the CSA to work together on an expedited basis to establish standards for audit committees that will make Canadian audit committees "best in class" internationally. We also encourage the CSA to be sensitive to the needs and resources of small-cap issuers in crafting any rule proposals.

16.3 Other Corporate Governance Requirements

In August 2002, both the NYSE and NASDAQ proposed a series of sweeping changes to their listing standards relating to the composition and functioning of boards of directors and compensation and nominating committees. In light of the increased public and regulatory attention that has been focused on corporate governance, we also considered whether the Commission should have rulemaking authority over corporate governance matters more generally.

Historically, securities legislation has focused attention on disclosure of information to investors and not on corporate management.[372] As one observer noted, however, "corporate governance issues and the integrity of securities markets are inextricably intertwined."[373] The structure and functioning of public companies, while clearly a "corporate" matter, affects not only company shareholders as "shareholders" but also as "investors."

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[370] See subsection 200(3) of the 2002 Amendments.

[371] See comment letters of the Certified General Accountants of Ontario, Ontario Teachers' Pension Plan, Davies Ward Phillips & Vineberg LLP, Fasken Martineau DuMoulin LLP, and the Canadian Bankers Association.

[372] Securities commissions do have authority, however, to deal with areas that have traditionally been viewed by some as "corporate" matters, such as insider trading, proxy solicitation, take-over bids, and related party transactions. Similarly, commissions may "regulate" corporate governance matters through the exercise of their oversight powers over SROs (e.g., oversight over the listing requirements of exchanges).

[373] Philip Anisman, "It's break point for break fees," *National Post* (March 18, 2002).

We also believe that there are practical considerations which support giving the Commission rulemaking authority over corporate governance matters more generally. First, the Commission can adopt reforms in a more flexible and timely manner through a process that permits all interested parties to participate, versus adopting reforms through corporate legislation. Second, the CSA, through national instruments, can more effectively develop harmonized national corporate governance standards than is possible at the corporate law level. Finally, this approach would also offer benefits from an enforcement and compliance perspective because corporate statutes, unlike securities laws, are largely self-enforcing.

We would therefore support giving the Commission rulemaking authority over corporate governance matters more generally. For example, we would support giving the Commission rulemaking authority to make rules relating to the composition, functioning and responsibility of boards of directors and nominating and compensation committees. We would also urge the Commission, however, to exercise caution and restraint in imposing new regulations in these areas. In particular, the Commission should ensure that any of its rule proposals take into account existing corporate requirements and are not overly burdensome to both large- and small-cap companies. Also, the Commission should continue to work with the exchanges on corporate governance matters where relevant to listings standards.

Recommendation:

We recommend that the Act be amended to give the Commission rulemaking authority over corporate governance matters more generally. For example, we would support giving the Commission rulemaking authority to make rules relating to the composition, functioning and responsibility of boards of directors and nominating and compensation committees.

PART 5

ENHANCING FUNDAMENTAL INVESTOR RIGHTS

When individuals become investors, they become entitled to certain rights. In this part, we discuss reforms aimed at enhancing investors' rights, including reforms in the area of proxy solicitations, take-over bid regulation and mutual fund governance.

SHAREHOLDER RIGHTS

The CBCA was recently amended to, among other things, facilitate communications among shareholders.[374] The Committee examined these amendments to determine whether comparable reforms are necessary under the Act.

17.1 Background

The CBCA and most other Canadian corporate statutes contain provisions relating to shareholder meetings, the process for soliciting proxies from shareholders who are unable to attend meetings, and materials to be provided to shareholders in advance of such meetings. In the case of the CBCA, these provisions were largely based on the Kimber Report, which was concerned that shareholders who are unable to attend meetings in person be able to appoint their own nominees to vote at meetings of shareholders.[375] Otherwise, the Kimber Report noted, the "marked tendency for management to perpetuate itself in office" would not be held in check and shareholders who were unable to attend meetings would not have a voice in the management of the company. The Kimber Report recommended that management provide an information or "proxy" circular to shareholders which contains sufficient information to enable shareholders to be knowledgeable about the proposals on which they are required to cast a vote.[376]

Like the CBCA, the Act also requires management of a reporting issuer to send a form of proxy to voting security holders in connection with every shareholder meeting.[377] Persons other than management (typically referred to as "dissidents") may also solicit proxies. The Act further provides that no one (whether management or dissident) shall solicit proxies unless the proxy is accompanied by an information circular.[378]

The terms "solicit" and "solicitation" are broadly defined and include any request for a proxy; any request to execute or not to execute a form of proxy or to revoke a proxy; and "the sending or delivery of a form of proxy or other communication to a securityholder under circumstances reasonably calculated to result in the procurement, withholding or revocation of a proxy."[379] These provisions do not allow communications to and among securityholders if the communications may reasonably result in obtaining a proxy unless certain prescribed information contained in a proxy circular is distributed to securityholders. Consequently, the provisions have effectively prevented shareholder communications in anticipation of a vote, unless a dissident proxy circular has been prepared.

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[374] The amendments to the CBCA were effected by the passage of *An Act to Amend the Canada Business Corporations Act and the Canada Cooperatives Act and to Amend Other Acts in Consequence*, proclaimed in force November 24, 2001 (SI/2001-114).

[375] Kimber Report, para. 6.02.

[376] *Ibid*. para. 6.24.

[377] The Act, section 85.

[378] The Act, subsections 86(a) and 86(b).

[379] The Act, section 84.

The Act contemplates certain exemptions from the rules relating to proxy solicitation.[380] For example, reporting issuers are exempt from having to comply with Part XIX of the Act if the issuer complies with "substantially similar" laws of the jurisdiction of incorporation.[381] The CBCA and the OBCA contain provisions that are similar in many regards to the Act.

17.2 Recent CBCA Amendments

The recent amendments to the CBCA relax the rules relating to proxy solicitation. The basic rule remains that a person shall not solicit proxies unless that person first prepares, files and delivers a proxy circular in the prescribed form.[382] However, now a "solicitation" does not include:

(a) a public announcement (such as a speech in a public forum or press release) by a shareholder of how the shareholder intends to vote and the reasons for that decision;[383] or

(b) a communication, other than a solicitation by management, that is made to shareholders in any circumstances that may be prescribed.[384]

Among the other CBCA reforms, a dissident shareholder may solicit proxies without preparing and sending a proxy circular to shareholders if the solicitation is, in the prescribed circumstances, conveyed by public broadcast, speech or publication.[385] Solicitations conveyed by these means must contain information regarding the identity of the shareholder, its percentage shareholdings and its interests in the matter being solicited.[386] Before the advertisement or other form of communication is released, it must be delivered only to the Director under the CBCA and the corporation.[387]

The amendments to the CBCA are consistent with rules adopted by the SEC in 1992 relating to proxy solicitation. The SEC was concerned that any expression of opinion concerning a public corporation could be viewed as a proxy solicitation. In its view, "the federal proxy rules [had] created unnecessary regulatory impediments to communication among shareholders and others and to the effective use of shareholder voting rights."[388] The SEC specifically highlighted newspaper opinion editorial articles, public speeches and television commentary as communications that could be interpreted as a regulated solicitation.[389] The SEC adopted amendments that would eliminate regulatory obstacles that prevented shareholders from exchanging views on management performance and initiatives.

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[380] Two exemptions not discussed here are contained in subsection 86(2) and subsection 86(3) of the Act.

[381] The Act, subsection 88(1). The provision states that "[w]here a reporting issuer is complying with the requirements of the laws of the jurisdiction under which it is incorporated, organized or continued and the requirements are substantially similar to the requirements of this Part, the requirements of this Part do not apply."

[382] CBCA, subsection 150(1).

[383] CBCA, paragraph 147(b)(v) and Canada Business Corporations Regulations, 2001 (SOR/2001-512), paragraphs 67(a) and (b).

[384] CBCA, subclause 147(b)(vii).

[385] *Ibid.* subsection 150(1.2).

[386] Canada Business Corporations Regulations, 2001, *supra* note 383 at subsection 69(1) and paragraphs 61(a) to (d).

[387] *Ibid.*, subsection 69(2).

17.3 The Need for Reform in Ontario

The ability of shareholders to communicate with each other is fundamental. As the Ontario Teachers' Pension Plan stated in its presentation to the Standing Senate Committee on Banking, Trade and Commerce:

> Shareholders must be informed. They must conduct continual research on the company. They must review policies, prospects and decisions. When questionable decisions are made, they must indicate their concern … Shareholders must speak with many people in the market. They must speak with each other to learn whether their views are widely shared or are a minority opinion. They must be able to speak with the company as individuals or as a group. When a problem surfaces, they must be able to discuss their concerns; when a corporate proposal is made that demands opposition, they must be able to act. The Canadian proxy rules … create substantial barriers to this kind of continued, informal communication among shareholders … The result is detrimental to shareholders, corporations and the integrity of the process itself.[390]

The Committee is concerned that the existing proxy solicitation rules in securities legislation are too restrictive in that they may discourage shareholders from communicating with each other. For instance, we note the interpretive difficulties with the definition of "solicitation," which includes communications that are "reasonably calculated to result in the procurement, withholding or revocation of a proxy."[391] Further, given that these interpretive difficulties have been eliminated in the CBCA, the fact that these rules continue to exist in the OBCA and the Act causes increased difficulties for shareholders in determining whether they can communicate among themselves. As one commenter noted: "Now that the CBCA has been amended, the doubts it purports to eliminate will be exacerbated, by comparison, in the Act and the OBCA."[392]

In the Draft Report we indicated our support for the amendments to the CBCA and recommended that Part XIX of the Act be similarly amended. We recommended that similar amendments be made to the OBCA so that companies incorporated under the OBCA are subject to the same regime as companies incorporated under the CBCA. We also suggested that, if feasible, the Act should incorporate by reference the requirements relating to proxy solicitation from other jurisdictions such as the provincial or federal corporate statutes.

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[388] SEC, *Regulation of Communications Among Shareholders*, 17 CFR Parts 240 and 249, Release No. 34-31326170, (22 October 1992).

[389] *Ibid.*

[390] The Standing Senate Committee on Banking, Trade and Commerce, "Corporate Governance" (August 1996) (http://www.parl.gc.ca/english/senate/com-e/bank-e/rep-e/cgo-e.htm at 49-50).

[391] The Act, clause 84(c); CBCA, clause 147(c); OBCA clause 109(c).

[392] See comment letter of Fasken Martineau DuMoulin LLP.

The majority of comments we received on our recommendation supported it, and support facilitating communication among shareholders.[393] One commenter disagreed with the recommendation as they felt that proxy solicitation matters are better dealt with by corporate legislation.[394] However, communications between an issuer and its shareholders are properly the domain of securities regulators given the importance of disclosure by issuers to the efficient functioning of the capital markets. Further, as the proxy rules are also currently contained in securities legislation, we continue to believe that the rules in both corporate and securities legislation should be identical, both so as to facilitate communication among shareholders and so as to eliminate interpretative difficulties with the current rules in the Act and the OBCA.[395]

Recommendation:

We support the reforms to the CBCA relating to proxy solicitation. We strongly recommend that Part XIX of the Act be similarly amended to ensure that shareholders are able to communicate with each other in prescribed circumstances without having to file an information circular. We also recommend that the Commission co-ordinate with the provincial government so as to ensure that amendments adopted under the OBCA and the Act are uniform. We further urge the Commission to consider whether it has the authority to incorporate by reference the requirements of another Canadian statute such as the OBCA or CBCA with respect to proxy solicitation, rather than stating the rules explicitly in the Act.

17.4 Shareholder Communications in the Context of a Take-Over Bid

The Committee also examined rules relating to shareholder communication in the context of a take-over bid. In particular, the Committee considered revisions to the proxy solicitation rules adopted by the SEC in 2000.[396] These changes were prompted by an increase in the number of merger and other acquisition transactions involving proxy or consent solicitations. The SEC noted that technological advances have resulted in more and faster communications with securityholders and the markets. Thus, the SEC implemented new rules that would:

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[393] See comment letters of Investment Counsel Association of Canada, Torys LLP, Ontario Teachers Pension Plan, and Fasken Martineau DuMoulin LLP.

[394] See comment letter of the Canadian Bankers Association.

[395] In June 2002, a number of Canada's largest pension plans, mutual funds and money managers formed the Canadian Coalition for Good Governance "to fight for improved governance at Canadian companies." Claude Lamoreux, President and CEO of Ontario Teachers' Pension Plan, one of the organizing members, stated that the Council was able to be formed because the CBCA Amendments "provide institutional investors with the opportunity to work together as shareholders" and to share information so as to take the initiative to hold management accountable for a company's growth. See www.otpp.com/web/website.nsf/web/CoalitionforCorpGov. The establishment of the Council is a positive example of the practical implications of the CBCA Amendments for communication among shareholders.

[396] SEC, *Regulation of Takeovers and Security Holder Communications*, 17 CFR Parts 200, 229, 230, 232, 239 and 240, Release No. 33-7760, 34-420055.

- relax existing restrictions on oral and written communications with securityholders by permitting the dissemination of more information on a timely basis, as long as the written communications are filed on the date of first use;
- permit more communications before the filing of a registration statement in connection with either a stock tender offer or a stock merger transaction;
- permit more communications before the filing of a proxy statement (whether or not a business combination transaction is involved); and
- permit more communications regarding a proposed tender offer without "commencing" the offer and requiring the filing and dissemination of specified information.[397]

The Committee encourages the Commission and the other members of the CSA to consider whether the take-over bid laws should be revised in a manner similar to the SEC rules, so as to permit communications with and among shareholders in less restrictive circumstances.

Recommendation:

We recommend that the Commission, together with the CSA, undertake further study to determine whether amendments to securities law to relax the requirements relating to communications with and among shareholders in the context of a take-over bid should be enacted.

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[397] *Ibid.* at 61408-61409.

TAKE-OVER BID REGULATION

Most CSA jurisdictions, including Ontario, have enacted legislation implementing the recommendations of the Zimmerman Committee.[398] Consequently, the Committee identified only a few areas of take-over bid regulation which require consideration at this time.

18.1 Arrangements/Take-Over Bids

The Committee considered whether the take-over bid provisions should be extended to transactions that are not structured as bids but that achieve the same result, such as arrangements that are intended to acquire control of a company. The CVMQ published a notice for comment on this subject in 2001.[399]

Some have argued that when an arrangement may lead to substantive results similar to those of a take-over bid, then parties to the arrangement should be required to comply with rules governing take-over bids. However, we note that arrangements attract a different set of safeguards from those associated with take-over bids. For instance, in the take-over bid context, the bidder deals directly with the target shareholders and rules such as the identical consideration provision prevent the bidder from discriminating among them. If a transaction is structured as an amalgamation or a plan of arrangement, the target company's board negotiates and approves the transaction. Shareholders must approve the arrangement by a two-thirds majority and separate class votes are available in many instances. A plan of arrangement is also subject to court approval, and shareholders of the target company are granted a right of dissent if they believe the offer price does not represent fair value. The two types of transactions need not be regulated in an identical manner. We believe that each transaction, and the legislative means to achieve the transaction, must be fair to all interested parties. We believe that investor protection concerns must be balanced with the public policy objective of retaining a flexible regulatory regime which allows parties the freedom to structure transactions to achieve their business objectives. Further, the Commission can always engage its public interest jurisdiction pursuant to section 127 of the Act where the transaction is abusive.

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[398] The Zimmerman Committee consisted of members of the IDA and was formed to review take-over bid time limits. The Zimmerman Committee issued a report in 1996 that recommended a number of changes in the regulation of take-over bids.

[399] CVMQ, Bulletin Hebdomadaire: 2001-06-29, vol. xxxii, no. 26.

Recommendation:

Nothing has come to our attention that would support the need to regulate arrangements and take-over bids in an identical fashion. We believe that, as a matter of public policy, parties to commercial transactions should have the freedom to structure transactions to achieve their business purposes as long as these transactions, and the legislation that governs these transactions, are fair to all interested parties.

18.2 Poison Pills

The most common defensive tactic is the shareholder rights plan, typically referred to as a "poison pill." Poison pills are sometimes adopted in the face of a take-over bid, or may be put in place when there is no bid pending. Poison pills are rarely, if ever, triggered. They are a device for negotiation and for extending the time period available to the target's board to seek alternative offers. In the context of a hostile bid, the target and the offeror are unlikely to agree as to when the pill will be terminated and the offer allowed to proceed.

Frequently, Commission hearings are convened in the context of hostile take-over bids so that the Commission can consider whether it is "time for the pill to go" and thereby permit the bid to proceed. These hearings consume considerable resources and entail significant cost. We note that guidance as to when it is time for a pill to go has been generated through decisions rendered in the context of specific poison pill hearings. In our Draft Report we recommended that the Commission should consider consolidating the experience and guidance which has come out of these hearings by preparing a policy statement outlining the considerations as to when in a take-over bid a poison pill should be terminated.

One commenter on this Recommendation disagreed with us, and felt that such a policy statement is both unnecessary and inappropriate.[400] Further, the commenter suggested that the Commission should rethink its "interventionist" approach to rights plans particularly as, in the view of the commenter, it has created an unlevel playing field between Canada and the U.S. and put Canadian companies at a serious disadvantage in comparison with their U.S. counterparts:

> One need only compare the situation of a Canadian target of a U.S. consolidator (which target may not be able to rely on structural defences to fend off an unwanted advance for more than a brief period of time because of the interventionist approach of the Canadian securities commissions) and a U.S. target of a Canadian consolidator (which may well be able to rely on its structural defences for an extended period or even indefinitely because of the very different approach to unsolicited bids adopted by the SEC). We believe that this unlevel playing field between Canadian and U.S. companies cannot be justified and is an important factor in the "hollowing out" of corporate Canada recently commented upon publicly by the Chief Executive Officer of the Royal Bank of Canada.

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[400] See comment letter of Davies Ward Phillips & Vineberg LLP.

We note with interest the point made by the commenter concerning the difference in regulatory approach to poison pills between Canada and the U.S. With respect to our recommendation concerning the policy statement, however, we disagree that it would be unnecessary or inappropriate. We recognize that each bid is fact specific, and while there appears to have been a decline recently in the number of poison pill hearings, we believe that an overall policy derived from the guidance in these decisions could be useful in obviating the need for hearings in the future to determine when it is time for the pill to go. This, in turn, should lead to fewer requests for intervention by securities regulators on a case-by-case basis, a result which the commenter favours.

Recommendation:

We recommend that the Commission prepare a policy statement setting out guidance as to the factors to consider in determining when, in the context of take-over bid, a poison pill should be terminated.

18.3 Break Fees

Break fees are fees which are negotiated between a take-over bid target and a bidder as part of the inducement for the bidder to make an offer to acquire the shares of the target. The fee is paid to the bidder if the board of directors of the target recommends accepting a competing offer. Often, break fees are in the amount of two to four per cent of the value of the target company, thereby adding two to four per cent to the cost of acquisition of the target company by a different, and successful, bidder.

Bidders who negotiate break fees argue that such fees are a necessary inducement for them to make an offer. Opponents of break fees argue they are an unjustified use of the target's asset (being cash) to prefer one bid over another.

Currently the use of break fees as a defensive tactic is not regulated by the Commission. One commenter on the Draft Report felt break fees should be regulated by the Commission:

> We believe strongly that an egregious break fee sewn into a take-over bid (or plan of arrangement), violates the public interest in just the same way as a poison pill. The Commission has no issue with striking down shareholder rights agreements that serve to entrench management and, in so doing, allow the shareholders to ultimately decide on the success or failure of a bid. We believe that a break fee can have the same desultory effect on the auction process as a poison pill.[401]

Alternatively, other people do not believe that the Commission is the proper forum to hear disputes about break fees. It is their view that it should be solely up to the board of directors of the target company to decide if a break fee is an appropriate payment for the company to make in the circumstances.

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[401] See comment letter of Ontario Teachers' Pension Plan.

Break fees are not in and of themselves offensive; it depends upon the purpose for which they are being used. The Commission can, and should, exercise its public interest jurisdiction in appropriate circumstances. Although we are of the view that there may be situations where, based on the facts surrounding the negotiation of a particular break fee, the Commission's public interest jurisdiction may be engaged, we do not believe that every use of break fees should be subject to a single regulatory standard.

18.4 Partial Bids

A partial bid is a take-over bid made by an offeror to acquire some, but not all, of the outstanding shares of the target corporation. The purpose of the partial bid is to allow the bidder to acquire a substantial enough position in the target so that the bidder may exercise *de facto* control or significant influence over the target, without incurring the cost of purchasing all the shares in the target which it does not own.

There is no prohibition in Ontario securities law, or the securities legislation of the other provinces and territories in Canada, against partial take-over bids. To the extent a partial bid constitutes a take-over bid for purposes of Part XX of the Act, it must be conducted in accordance with the take-over bid regime set out in Part XX; however, nothing in Part XX requires that any proposed take-over bid made must be for all of the issued and outstanding shares not then owned by the bidder. In this respect, Canadian regulation of take-over bids is similar to the approach in the U.S., where partial bids are also permitted. In contrast, in the U.K. the legislation provides that the Panel on Take-overs and Mergers must approve any partial bid, and if an offer is made that will result in the offeror owning more than 30 per cent of the issued and outstanding shares of the target, then the offer must be conditional on receiving the approval of shareholders holding more than 50 per cent of the target's voting securities not held by the offeror.

There are two schools of thought concerning partial bids. One school of thought tends to view partial bids as coercive. After the completion of the partial bid, there is less liquidity for trading in the shares since there are fewer shares still trading in the public market. Further, it is unlikely that another bidder will make an offer to acquire the remaining shares in the company given the ownership position of the bidder. Finally, in situations where the partial bid results in the offeror owning more than 50 per cent of the shares of the target, the remaining shares will constitute a minority position in the company. For these reasons, critics of partial bids are concerned that shareholders may feel compelled to tender to a partial bid in order to realize at least some premium, and accordingly, they are not able to react to the bid on its merits.[402]

The other school of thought is that partial bids are not inherently coercive. Shareholders are competent to make their own decisions as to whether to tender to a bid, partial or otherwise. Facilitating change of control transactions, where shareholders are able to influence the outcome of the transaction by deciding whether to tender, or not, is important.

The Commission has had occasion to consider partial bids in the context of certain poison pill hearings. In *In the Matter of Ivanhoe III Inc. and Cambridge Shopping Centres Limited*,[403] the Commission acknowledged that partial bids could be coercive and allowed the poison pill (which Cambridge had put in place in the face of a partial bid), additional time to operate. Two years later, in *In the Matter of Chapters Inc. and Trilogy Retail Enterprises L.P.*,[404] the Commission considered whether a pill put into place by Chapters in the face of a partial bid by Trilogy could stay in place until a subsequent bid for all the outstanding shares, made by a white knight, could be prepared and mailed to shareholders of Chapters. In its decision, the Commission qualified its decision in *Ivanhoe* noting that, while in that case it had agreed "in general" with the view that partial bids are coercive, "Chapters cannot simply rely on Ivanhoe as establishing the principle that partial bids are *ipso facto* coercive." In the *Chapters* situation, the Commission was not persuaded that the bid would result in a less liquid market or less valuable minority interest. The decisions of the Commission in *Ivanhoe* and in *Chapters* suggest a willingness on the part of the regulator to continue to allow partial bids, but to deal with allegations of coercion in the context of such bids on a case-by-case basis.

In the Draft Report we invited comment on whether there should be a change in regulatory approach in Ontario to partial take-over bids, and if so, what the new regulatory response should be. Two commenters responded.[405] One acknowledged that shareholders of a target company may have to consider different factors when determining whether to tender to a partial bid than when determining whether to tender a bid for all the shares of a company.[406] The commenter did not feel there is currently any overriding public interest in favour of protection of shareholders of a target company which would necessitate a change in the present regulatory structure concerning take-over bids. The commenter suggested the CSA should undertake an informed study of the matter. The other commenter did not support additional regulation of partial bids as a general matter.

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[402] See *In the Matter of Ivanhoe III Inc. and Cambridge Shopping Centres Limited* (1999), 22 OSCB 1327 at 1329.

[403] *Ibid.*

[404] (2001), 24 OSCB 1064 and 1663.

[405] See comment letters of Fasken Martineau DuMoulin LLP and Davies Ward Phillips & Wineberg LLP.

[406] See comment letter of Fasken Martineau DuMoulin LLP.

We have not found any need for legislative change in this area, and accordingly have no recommendations concerning the regulation of partial bids.

18.5 Mini-Tenders

Mini-tenders are widely disseminated offers to acquire less than 20 per cent of the outstanding securities of a class, typically at a discount to the current market price of such shares. Because they are offers for less than 20 per cent, they fall outside the provisions of Part XX of the Act, which impose rules governing the conduct of take-over bids. The Committee discussed whether "mini-tenders" should be subject to regulation by the Commission.

In 1999, CSA staff issued a notice outlining its concerns and recommendations relating to mini-tenders.[407] The Mini-Tender Notice focused on potentially abusive mini-tenders where investors are unaware that they are tendering to a below-market offer that is not regulated under provincial securities legislation. Staff recommended that mini-tenders should include information such as the principal market for the securities; a warning that the offering price is below the current market price; and a statement that people tendering to the offer should consult their financial advisers.

We do not believe legislative amendments is necessary to address mini-tenders. We believe that the most effective mechanism for dealing with inappropriate or abusive conduct in connection with mini-tenders is through investor education and enforcement proceedings in appropriate cases.[408] In our Draft Report we had recommended that the Act be amended by adding a provision which would prohibit market manipulation and fraudulent activity. The 2002 Amendments contain such a provision. We believe that this will enable the Commission to deal with those cases which involve mini-tenders that are conducted in an abusive, misleading or deceptive manner. We also note that mini-tender concerns appear to have subsided to some extent since the publication of the Mini-Tender Notice.

18.6 Convertible Securities

The Committee also examined the application of formal take-over bid rules to convertible securities. The anti-avoidance provision contained in section 92 of the Act provides that an offer to acquire "shall be construed to include a direct or indirect offer to acquire or the direct or indirect acquisition or ownership of securities . . . ." In interpreting this provision, it is unclear when a purchase of convertible debentures constitutes the purchase of the underlying shares as opposed to the debenture. This issue has implications for the way in which other provisions of Part XX of the Act are interpreted and applied. For instance, if an offer to acquire convertible securities is an offer to acquire the underlying shares, must the price offered for convertible securities be identical to the price offered for common shares in the direct offer made to common shareholders?[409]

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[407] CSA Staff Notice 61-301, *Staff Guidance on the Practice of Mini-Tender* (1999), 22 OSCB 7797 (the "Mini-Tender Notice").

[408] In SEC Release #34-43069; IC-24564 "Commission Guidance on Mini-Tender Offers and Limited Partnership Offers" the SEC outlines examples of certain mini-tender practices which may be fraudulent, deceptive or manipulative practices within the meaning of section 14(e) of the *Exchange Act*.

We note that there are opposing views within the legal profession regarding the interpretation of section 92. One view is that one must assess the true intention behind an offeror's purchase of the convertible securities. If the intention is to acquire the underlying shares, then the offer for the convertible securities will be characterized as an offer for the underlying shares. There is no need to regulate all acquisitions of convertible debt as take-over bids but, rather, to have the Commission exercise its public interest jurisdiction in the rare, abusive situations.[410] Others find the subjective test unacceptable and believe that further clarity is required as to when an offer for convertible debt is an offer for underlying shares.

We are inclined to the view that providing absolute certainty in this area ultimately would not be constructive. The purpose for acquiring convertible securities will vary from transaction to transaction, and each transaction needs to be analyzed in the context of its circumstances, facts and commercial details to determine the objective of the transaction, the true intent of those who designed it and whether it should comply with the take-over bid rules.

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[409] See William Ainley, *Legal Developments in Canadian M&A Practice* (Toronto: Insight Information Co., 2000).

[410] See comment letter on Issues List of James Turner.

MUTUAL FUND GOVERNANCE

In considering whether any changes are needed to the regulatory regime governing mutual funds, we focused primarily on fund governance.

19.1 Background

A mutual fund is an investment vehicle for retail investors. The assets of the investors are pooled in one portfolio and are managed by professional money managers.

Mutual funds are organized and promoted by a company which is typically referred to as the "mutual fund manager" or "manager." In establishing a mutual fund, the mutual fund manager organizes the fund; arranges for the offering documentation of the fund to be prepared, filed and cleared with securities regulatory authorities in every province in which the fund will be offered for sale to the retail public; and takes on the management, administrative and investment management responsibilities associated with operating the fund on an ongoing basis. The manager may provide these services directly or may subcontract with third parties to provide these services to the fund on its behalf. The manager is paid a fee by the mutual fund for providing these services.

Conflict issues in the mutual fund industry may arise because the manager is an entity separate from the mutual fund itself and is in business to make a profit for its shareholders from its management function. This may place the manager in a conflict of interest when making decisions as to the management of the fund as some decisions that are profitable for the manager and its shareholders may not be in the best interests of investors in the fund.[411] The conflicts of interest are compounded when managers are not managers of one fund only but of a number of funds.[412] The questions then become, whose job is it to safeguard the interests of the mutual fund, and can we reasonably expect the manager to fulfil that role?

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[411] For example, in determining the allocation of expenses as between the manager and a fund, the manager may be tempted to characterize as fund expenses certain items that are more appropriately characterized as expenses of the manager carrying out its management obligations to the fund. Or, if a fund is performing poorly, the portfolio manager should perhaps be terminated but if the portfolio manager is an affiliate of the manager, and is bringing additional fees into the management complex for its services, the manager may be disinclined to terminate the portfolio manager.

[412] For example, a manager may choose to allocate more resources to funds with better performance records and, in effect, orphan its lesser-performing funds.

There is at this time no legislative requirement to ensure that there is a player in the mutual fund family, independent of the mutual fund manager, whose role is to ensure that the interests of the unitholders are taken into account by the manager.[413] A mutual fund investor has no remedy if he or she is displeased with the performance of the management company, other than to exit the mutual fund. The decision to exit will generally attract negative economic consequences.

Mutual fund governance has been the subject of a number of studies in Canada in the past 35 years. While all of these reports have recognized the importance of independent oversight, they have reached different conclusions regarding the need to legislatively mandate this requirement.

The *Report of the Canadian Committee on Mutual Funds and Investment Contracts* (the "1969 Report") noted there are certain types of risks that investors in mutual funds would not generally be assumed to have accepted in making their investment decisions, including risks arising from the lack of independent oversight. The 1969 Report continued:

> The best protection against the types of risks here being considered would be an arrangement whereby the management company and the distribution company were subjected to continuing independent scrutiny over their operations. This scrutiny might be provided by the mutual fund investors, or by a surrogate acting on their behalf; what is essential is that the procedure used be effective but not interfere unduly with the freedom of management to make investment decisions.[414]

However, the 1969 Report stopped short of recommending a statutory requirement for each mutual fund to have a board of directors or equivalent body or that a specified percentage of the members of such bodies be independent of management, although it suggested there could be voluntary adoption of such a structure.

A report prepared for the Department of Consumer and Corporate Affairs in 1974 also considered whether a system of fund governance was necessary in the Canadian mutual fund industry, but concluded that:

> Except in special circumstances the mutual fund should not be treated as a separate entity from its investment manager, requiring a separate board of directors.[415]

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[413] Section 116 of the Act, however, does provide that "every person or company responsible for the management of a mutual fund shall exercise the powers and discharge the duties of its office honestly, in good faith and in the best interests of the mutual fund, and in connection therewith shall exercise the degree of care, diligence and skill that a reasonably prudent person would exercise in the circumstances."

[414] *Report of the Canadian Committee on Mutual Funds and Investment Contracts – Provincial and Federal Study* (Ottawa: Queen's Printer, 1969) at 151.

[415] J.C. Baillie and W.M.H. Grover, *Proposals for a Mutual Fund Law for Canada*, vols. I & II, Consumer and Corporate Affairs (Ottawa: Information Canada, 1974) [hereinafter the 1974 Proposals], in Vol. I at 3-4.

More recent reports strongly support the adoption of a fund governance regime in Canada. In *Regulatory Strategies for the Mid-90's: Recommendations for Regulating Mutual Funds in Canada* (the "Stromberg Report"), former Commissioner Stromberg stated that:

> There is something inherently wrong with a structure that permits all the functions that are required to be carried out in respect of an investment fund to be carried out by related parties on terms that are in effect unilaterally imposed without there being some degree of review by unrelated persons who are considering the merits solely from the perspective of the best interests of the investment fund and its investors.
>
> In the current structure, there is no one whose sole responsibility it is to look out for the interests of investors and it is not clear that the primary obligation of the investment fund manager is to put the interests of its sponsored investment funds ahead of all other interests. ... [I]nvestment fund organizations are focussed on gaining market share and benefiting their shareholders and other stakeholders. Their focus is not exclusively on their obligations to their sponsored investment funds.[416]

Consequently, the Stromberg Report contained a recommendation that each investment fund should be required to have an independent board. Former Commissioner Stromberg stated:

> I believe that there is justification for this [recommendation] by reason of the unique relationship that exists between the investment fund and its manager. This relationship gives rise to conflict of interest situations that occur on a continuing basis in the ordinary course of business and otherwise. In view of the fact that it is impractical for each situation involving a conflict of interest to be referred to security holders for approval, it is essential that there be an independent body whose sole focus is the interests of the investment fund and its security holders.[417]

The Investment Funds Institute of Canada and the Commission jointly established a steering group (the "Steering Group") to review and respond to the Stromberg Report. In its report, the Steering Group agreed in principle with the recommendations of former Commissioner Stromberg, but ultimately recommended that each fund family, rather than each fund, should have a board of at least five members, the majority of whom are independent of the manager, and an audit committee comprised entirely of independent members of the board.[418] Further, the Steering Group recommended that the fund family board should not have the power to terminate the manager.

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[416] G. Stromberg, *Regulatory Strategies for the Mid-90's: Recommendations for Regulating Investment Funds in Canada*, prepared for the CSA (Toronto: Ontario Securities Commission, January 1995) at 147-148.

[417] *Ibid*. at 152.

[418] Investment Funds Steering Group, *The Stromberg Report: An Industry Perspective*, prepared for the CSA (Toronto: Queen's Printer, November 1996) at 50-51 [hereinafter the Steering Group Report].

In Canada, the most recent report to consider the matter of mutual fund governance was produced for the CSA by Stephen Erlichman in August 2000.[419] The Erlichman Report provides an overview and analysis of the historical consideration of mutual fund governance in Canada and a review of the governance structures which could be adopted by the mutual fund industry in Canada. The Erlichman Report recommended that each mutual fund family should be required to establish a governance regime that has a governing body independent from the manager of the mutual fund. The report does not insist upon a particular governance structure. Rather, it states that if regulators choose to mandate one specific form of fund governance, then each mutual fund should have a "corporate style" board (of governors, trustees or directors, as the case may be), which should be comprised of at least a majority of independent directors. The sole interest of this governance board would be to focus on the best interests of the mutual fund and its unitholders.[420]

On March 1, 2002, the CSA issued a Concept Proposal concerning the regulation of mutual funds in Canada.[421] In the Concept Proposal, the CSA outlines its vision for regulating the mutual fund industry in Canada in the future, including its proposals to improve mutual fund governance. The Concept Proposal recommends requiring a governance agency which is independent of the mutual fund manager that will supervise the manager's management of its funds and will act to ensure the funds are managed in the best interests of investors. The governance agency would be vested with specific responsibilities including meeting regularly with management; overseeing and monitoring the manager's compliance with policies and procedures; acting as an audit committee; and monitoring that funds are managed in accordance with their stated investment objectives and strategies. The Concept Proposal was open to comments until June 7, 2002, and the CSA is currently reviewing the many responses received.[422]

On November 14, 2002, the BCSC published for comment a paper entitled "New Proposals for Mutual Fund Regulation."[423] The Proposals developed further some of the thinking of the BCSC reflected in a paper it published in February 2002 entitled "New Concepts for Securities Regulation." The Proposals addressed a number of topics relating to the mutual fund industry, including the disclosure documents to be prepared by mutual funds and the ability of foreign funds to be offered for sale in Canada.

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[419] Stephen Erlichman, *Making it Mutual: Aligning the Interests of Investors and Managers*, prepared for the CSA, (June 2000) [hereinafter the Erlichman Report].

[420] *Ibid*. at 8-11.

[421] CSA Concept Proposal 81-402, *Striking a New Balance: A Framework for Regulating Mutual Funds and their Managers* (2002), 25 OSCB 1227 [hereinafter, the Concept Proposal].

[422] The CSA received 57 responses concerning the Concept Proposal.

[423] BCSC, Notice 2002/46, "New Proposals for Mutual Fund Regulation."

The Proposals also suggested a new approach to governing business practices and product regulation in the fund industry. Detailed rules would be replaced by codes of conduct applicable to fund companies, advisers and dealers which would set out general principles for business practices and product regulation. The proposed Code of Conduct for fund companies would require a fund company to: (i) ensure it has a governance structure suitable for the structure of its funds and which addresses the conflicts of interest the company faces; (ii) have the members of the governance structure responsible for ensuring that management has appropriate compliance systems in place to deal with conflicts of interest; and (iii) disclose governance practices including whether the body is independent of the fund company. The Proposals deliberately did not set out the responsibilities of the governance body. The Proposals acknowledged that setting out specific responsibilities provides consistency in the marketplace and investor certainty about the structure of governance in the industry, but preferred to allow fund companies to determine the appropriate responsibilities of their governance body.[424]

In the U.S., the *Investment Company Act of 1940* (the "1940 Act") has contained long-standing provisions requiring investment companies to have boards of directors including independent directors. On January 2, 2001, the SEC adopted rules and rule amendments regarding investment company fund governance and the role of independent directors of investment companies. The effect of the rules and rule amendments is to require a majority of the board of directors to be independent of the manager if the investment company wishes to rely on exemptive rules contained in the 1940 Act to engage in certain self-dealing transactions. Furthermore, the independent directors must select and nominate any other independent directors and their legal counsel, who must also be independent of the manager.

19.2 The Case for an Independent Mutual Fund Governance Requirement

In considering the question of mutual fund governance, the Committee was guided by our principle that there must be a compelling public policy reason to introduce regulation. We also took into consideration the fact that most major jurisdictions other than Canada have some form of a mutual fund governance requirement, and considered whether there is anything particular to the mutual fund industry in Canada that justifies the continued absence of such a requirement in Canada.

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[424] In Consultation Paper 81-403, *Rethinking Point of Sale Disclosure for Segregated Funds and Mutual Funds* issued in February 2003, the BCSC has indicated its intention to put its efforts into the proposals reflected in the consultation paper rather than to proceed at this time with its own mutual fund proposals as a separate initiative.

The fundamental reason for requiring mutual fund governance in Canada is that the structure of the fund industry is by definition conflicted and there is no one whose sole responsibility is to protect the interests of unitholders. The fund manager is responsible for establishing the fund, managing the fund, retaining the investment manager for the fund, setting fees paid to the investment manager and the manager, and settling all expenses to be charged to the fund. At the same time, the management company is in business to do all of this in a manner most profitable to the shareholders of the management company. That the profit may be enhanced by increasing fees or expenses to the mutual fund, and therefore its unitholders, is disciplined only by market forces. An efficient market would dictate that a mutual fund with high fees and expenses would be less likely to be purchased. Undoubtedly, many mutual fund managers also see the correlation between success by the funds they manage and success for themselves. Nevertheless, the reality of the Canadian mutual fund industry is that manufacturers of mutual funds are primarily in the business of marketing their mutual funds, and a number of the marketing techniques employed encourage investors and their advisers to purchase funds that may have higher fees and expenses than competing mutual funds, either because of successful advertising or because of favourable compensation structures for advisers who recommend the mutual funds.

We believe that the introduction of a system of mutual fund governance in Canada, so as to provide oversight of the functioning of the mutual fund which is both independent of the management company and focused exclusively on the best interests of the unitholders, is overdue. Currently there is no constituency to exercise oversight on behalf of mutual fund investors and to raise issues of concern to them. Further, it is likely that implementing specific requirements for oversight of the operation of mutual funds will assist managers in establishing and maintaining appropriate policies and standards of conduct to govern themselves and the funds they manage.

We received a number of comments concerning our recommendation in the Draft Report that the Commission and the CSA should introduce a requirement for all publicly offered mutual funds to establish and maintain an independent governance agency.[425] Commenters were divided as to whether they supported this recommendation. This split is consistent with the response the CSA has received concerning the Concept Proposal.[426] Those commenters who support the recommendation do so because of the conflicts inherent in the mutual fund industry:

> We are of the opinion that the time has finally come to address the issue of the governance of mutual funds. The potential for conflict of interest is ripe when dealing in management of mutual

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[425] See comment letters of the Independent Financial Brokers of Canada, Ontario New Democratic Party, Fasken Martineau DuMoulin LLP, Investment Funds Institute of Canada, Larry Schwartz, Ontario Teachers' Pension Plan, Investment Counsel Association of Canada, Ogilvy Renault, Nova Scotia Securities Commission, Royal Bank of Canada, Investment Dealers Association of Canada, and BCSC.

[426] See comment letter of Fasken Martineau DuMoulin LLP, which states that in reviewing the comment letters the CSA has received on the Concept Proposal, the CSA has indicated that there is no clear consensus in Canada that an independent governance body is needed.

> funds and we agree with the Review Committee that it is [not] to say that just because there has been no publicly reported cases of abuse, one can safely conclude there is no concern. The very fact that the manager of a mutual fund is an entity apart from the mutual fund itself and is in business to make a profit for its shareholders presents a very serious conflict of interest situation for investors of this fund and this situation cannot be overlooked longer.[427]

Some commenters support the concept of an independent governance agency but insist it should only be introduced if there is a concurrent relaxation of certain existing rules governing mutual funds.[428] On the other hand, one commenter is adamantly opposed to any sort of regulatory quid pro quo:

> It is a dangerous precedent for statutory regulators to succumb to industry demands that there be trade-offs for new regulatory requirements. Regulatory reforms should serve a purpose and not come at an expense to investors.[429]

We also received a suggestion that the adoption of fund governance should be voluntary and not mandatory.[430]

Commenters who are opposed to the recommendation are either not convinced that the case has been made for the necessity of such a body or are concerned that any potential benefit would be outweighed by potential costs.[431]

We acknowledged there is no clear consensus in Canada as to whether there should be an independent governance body for mutual funds. Nevertheless, we continue to believe that the presence of experienced, independent people on a board (or other equivalent body) of a mutual fund will improve the process by which decisions are made and, therefore, the results for unitholders. A strong, independent governance body is a discipline on the manager and on management of the mutual fund; for example, some business plans, cost allocations or marketing programs will not receive the approval of a strong, independent governance body, which will in turn cause management to develop alternative plans, allocations or programs. Independent directors can also scrutinize management performance and fees. Such results can only be of benefit to the entire industry. The existence of a governance body to which management is accountable would also cause management to establish written policies and procedures where informal practices had existed, and to submit them to third-party scrutiny.

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[427] See comment letter of Ontario Teachers' Pension Plan.

[428] See comment letters of Investment Funds Institute of Canada and Royal Bank of Canada.

[429] See comment letter of Nova Scotia Securities Commission.

[430] See comment letter of Investment Funds Institute of Canada.

[431] See comment letters of Larry Schwartz, Independent Financial Brokers of Canada, and BCSC.

The Committee is aware, however, that the implementation of a system of mutual fund governance will be difficult in Canada. There will be costs involved in attracting and retaining directors for each mutual fund or family of mutual funds. These costs will likely be borne by mutual funds and, by implication, their investors. However, the existence of an independent governance body will help to protect the interests of unitholders so that the cost of establishing and maintaining the governance body should be recouped by its vigilance on behalf of the unitholders.[432]

The Committee also considered whether the independent governance body should have the right to terminate the manager for any reason. We are mindful of the fact that the manager took the initiative to found, organize and sponsor the mutual fund and that, if the manager is terminated for any reason, this could be seen as an expropriation of the manager's property interest in the fund. On the other hand, the moment the manager offers the mutual fund for sale to the public, the unitholders become stakeholders and the manager assumes an obligation to them. Indeed, there is a fiduciary relationship between the mutual fund manager and the investors. Furthermore, the independent governance body's sole mandate will be to act in the best interests of the unitholders of the fund. Failure to empower the independent governance body to terminate the manager for appropriate cause will create serious difficulties for it in fulfilling its obligations to the unitholders.

We therefore believe that the independent governance body should have the right to terminate the manager. In our Draft Report we recommended that the governance body should have the right to do so at any time when, in the reasonable opinion of the independent directors: (i) there is cause (including poor performance of the fund); or (ii) when the interests of the manager have been placed ahead of the interests of the unitholders through self-dealing, conflict of interest transactions, or other breach of fiduciary obligations. We received a number of submissions on this point.[433] Many commenters did not favour allowing the independent governance body to terminate the manager for poor performance. As one commenter noted:

> The criteria to terminate a manager for poor performance would be difficult and probably unacceptable in many instances. After all, in a statistical universe the majority of managers do not meet the benchmark indexes, which ultimately qualifies them for firing. This is the law of averages, which means that most managers will continually be fired and probably rehired elsewhere. Any suggestion that members of such Boards would be better equipped to make financial investment decisions for someone else's money, in our opinion, is incorrect. Also, the ability to expropriate a manager from his position of financial interest for something other than fraud or misleading conduct, in our opinion, is inappropriate.[434]

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[432] In their comment letters, Independent Financial Brokers of Canada and the Investment Funds Institute of Canada raised the concern that the costs involved will be even more difficult for small fund companies to bear.

[433] See comment letters of the Independent Financial Brokers of Canada, Larry Schwartz, Royal Bank of Canada, and the Investment Dealers Association of Canada.

[434] See comment letter of Independent Financial Brokers of Canada.

We agree. We have therefore amended our recommendation to remove the ability of the independent governance agency to terminate the manager for poor performance.

We have also considered whether it is sufficient to give the governance agency only one remedy – the power to terminate the manager – where the interests of the manager have been placed ahead of the interests of the unitholders. There may be circumstances where a governance agency feels the costs to unitholders of terminating the manager are too detrimental for it to want to exercise this remedy. We believe that the governance agency will best be able to exercise its fiduciary obligations to unitholders if it can adopt a solution which is most appropriate to all the facts and circumstances of the situation and which will best reflect the best interests of the unitholders. Consequently, we believe that the governance agency should have two alternative remedies available to it where a manager has placed its interests ahead of the interests of unitholders. One remedy would be to terminate the manager. Another remedy would be to notify the unitholders of the manager's behaviour and to provide unitholders with a period of time, likely 30 days, in which to redeem their units without cost. Under this second remedy, the decision as to whether to terminate the manager is made by each unitholder who elects to redeem his or her units rather than by the governance agency on behalf of all unitholders.

Recommendation:

We recommend that the Commission and the CSA introduce a requirement for all publicly offered mutual funds to establish and maintain an independent governance body. When, in the reasonable opinion of the independent directors, the manager has placed its interests ahead of those of unitholders of a mutual fund through self-dealing, conflict of interest transactions or other breach of its fiduciary obligations, this body should have the right either to terminate the manager or to tell the unitholders about the manager's actions and provide unitholders with a period of time within which to redeem their units at no cost.

19.3 Conflicts of Interest

Certain fund managers support fund governance because National Instrument 81-102, which governs mutual fund structures and operations in Canada, as well as Canadian securities legislation, prohibits mutual funds from engaging in certain self-dealing activities. These industry participants have suggested that the presence of an independent board would remove or at least lessen the need for these prohibitions in the governing legislation as the independent board could determine whether any particular transaction or arrangement would compromise the interests of the unitholders of the fund.

We believe that the types of conflicts of interests which a governance agency will address will go beyond those currently addressed in securities legislation. A governance agency is not simply an alternative to current prescriptive conflicts rules in securities legislation. We imagine that governance agencies will also deal with matters such as the allocation of expenses between the manager and the fund; allocation of trades and trading revenue to brokerages; soft dollars; personal trading by portfolio managers; and voting of proxies.

It is possible that once governance agencies are well established and understand the fund industry, its business and its conflicts, some of the current conflicts rules can be eliminated. We do not believe they should be eliminated until a transition period has expired, however, as governance agencies need to understand their function, their relationship with the fund manager and how and why the current conflict rules exist and work before their judgement should be substituted for current rules.

As the rules governing conflicts matters are relaxed or eliminated it will become increasingly important that each mutual fund disclose the approach it has adopted to the various conflict scenarios. Currently there is general consistency of approach to those conflicts which are regulated. When consistency is replaced by the discretion of the governance agencies, investors will need to be able to make informed choices among funds in these matters.

19.4 Recruiting Qualified Mutual Fund Directors

A second and critical concern with establishing a fund governance system is the ability to find a sufficient number of qualified people to serve as directors. There are currently in excess of 1,700 mutual funds and 70 mutual fund management companies in Canada. The Committee is concerned that, unless a new approach to selecting, recruiting and nominating directors is adopted, the Canadian marketplace will be strained to field the appropriate number of qualified directors.

The current process for identifying and recruiting public company directors in Canada relies extensively on a network of experienced directors who are familiar with other directors and their capabilities, and who rely on this information in recommending new directors. This process is reinforced by the reluctance both of recruiters to look at individuals below the level of CEO of companies, and of certain companies to allow employees other than the CEO to act as directors. While the Committee refrains from commenting generally on these practices, we do believe that the introduction of a requirement for mutual fund governance bodies provides an excellent opportunity for the introduction of new approaches to recruiting directors.

We believe that there is a sufficient pool of talent available in Canada to support a new governance regime for mutual funds, but that pool of talent will only be accessed if the traditional process for recruiting and nominating directors is modified. We believe that mutual funds and their nominating committees should expand the pool of talent they will consider to include individuals below the ranks of CEOs, as well as retired professionals. Non-profit organizations such as universities, business schools and hospital administrations should also be viewed as potential sources of directors. Commenters on this recommendation agreed with us.[435]

In addition to finding and attracting potential directors, mutual funds will need to ensure that the majority of directors are completely independent from the management company. This issue presents challenges since the management company will nominate the first directors. If the first and subsequent directors are not independent, then effective governance may be compromised. Mutual fund governance rules will need to set out a test or definition of independence.[436]

Recommendation:

We recommend that the process by which potential directors of mutual fund governance bodies are identified and nominated be expanded so as to include a broader range of potential directors. We further recommend that the majority of directors be independent of the management company. Lastly, the potential liability and defences available to directors of fund governance agencies needs to be settled in the legislation.

19.5 How the Independent Governance Body Will Look

The Committee identified a number of elements that should comprise a mutual fund governance model:

- The governance body should be independent from the manager and should have a mandate to act only in the best interests of the fund and its investors.
- The majority of directors must be independent of the management company but should not be the same as any independent directors of the management company. It is our strong belief that there is no reason to have a governance agency if a majority of its members are not independent of the manager.

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[435] See comment letters of Fasken Martineau DuMoulin LLP, Ontario Teachers' Pension Plan and Royal Bank of Canada.

[436] One additional issue relating to attracting potential directors relates to their potential liability as directors. A director of a corporation is liable if the director does not meet the standard of care the law imposes on directors, and the director's liability is in theory unlimited. However, the courts have over time articulated defences which directors can raise to a charge of breach of the standard of care, including the "business judgement rule." The availability to directors of a fund's governance agency of defences which courts have developed for directors of corporations is unclear. We believe governance agency directors should have the same responsibilities, liabilities and defences as corporate directors; a legislative solution may be required.

- The independent governance body should have the ability to fix its own fees based on such advice as it may seek to rely on, including the advice of an independent compensation adviser. The members of the governance body must disclose annually the fees they receive from that fund and all other funds in the same family.[437]
- The number of governance bodies that is appropriate for each family of mutual funds will depend upon a number of factors particular to that family of funds. We do not want directors to be overburdened with respect to the number of funds for which they will be responsible. We do not propose that the regulator specify a definitive limit on the number of mutual funds that may be overseen by any one governance agency. However, we are concerned that this determination should not be made solely by the manager, given its conflict. It is appropriate for the independent mutual fund governance body to decide how many mutual funds it should be responsible for overseeing, and for publicly disclosing its reasons if it does not limit, or cap, the number of funds within one fund family for which it is responsible.
- Members of the independent governance body should have the right to retain counsel independent of counsel to the fund manager and should have the right to retain other independent advisers as well.
- The independent governance body should have the right to terminate the mutual fund manager in circumstances where, in the reasonable opinion of the independent directors, the mutual fund manager has placed its interests ahead of those of the mutual fund unitholders through self-dealing, conflict of interest transactions, or other breach of fiduciary obligations (see discussion above in section 19.2).
- The names and contact information of the directors should be published annually and otherwise made available to unitholders so that unitholders have access to those who are acting in their best interests.

Recommendation:

We believe that the mutual fund governance body should have certain characteristics, including: independence from the manager; a majority of independent directors; the right to retain counsel and other independent advisers; the right to set its compensation and establish the obligation of each member to disclose annually all fees received from the fund and all affiliated funds; and the right to terminate the manager in specified circumstances.

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[437] Some commenters on the Draft Report disagreed with this suggestion and felt that since the manager will pay the fees, it should set them. We strongly disagree, as the independence of the members of the governance body could be perceived of as being impaired if the manager determines their fees. Public disclosure by members of their fees is, in our view, a sufficient discipline on the quantum of their fees.

19.6 Functions of the Governance Body

We also considered what the responsibilities of a governance body should be. While this list is not exhaustive, we believe the body should have responsibilities similar to those of a corporate board, including:

- overseeing the establishment and implementation of policies related to matters material to investors and relating to conflict of interest matters such as related party transactions, pricing, brokerage allocation and soft dollars;
- reviewing compliance with such policies;
- monitoring fees and expenses and their allocation;
- receiving reports from the manager concerning compliance with investment goals and strategies;
- reviewing the appointment of the fund's auditor, and considering whether the auditor should be separate from the auditor of the management company;
- meeting with the fund's auditor, which should report to the governance body, not the manager or management company; and
- approving material contracts.

Recommendation:

We believe that it is important to identify certain fundamental responsibilities of the mutual fund governance body. We believe these responsibilities should include, at a minimum, overseeing the establishment and implementation of policies related to conflict of interest issues; monitoring fees, expenses and their allocation; receiving reports from the manager concerning compliance with investment goals and strategies; reviewing the appointment of the auditor; meeting with the fund's auditor; and approving material contracts.

19.7 Should Mutual Fund Managers Have to be Registered to Carry on Business?

In our Draft Report we considered whether mutual fund managers should be registered or otherwise regulated. Currently managers are not required to be registered to carry on business as a mutual fund manager. A number of the past reports on mutual fund governance have recommended that fund managers be registered with the securities regulatory authorities.[438] The rationale for this recommendation is that managers of mutual funds play a pivotal role in establishing, promoting and running a mutual fund. Further, because of the range of services provided to a fund by a manager, or overseen by a manager, an investor could risk impairment to, or loss in value of, his or her investment if a manager failed to discharge its obligations fully, in a timely manner, and in a manner free from potential conflicts of interest.

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[438] Including the 1969 Report, the 1974 Proposals, the Stromberg Report and the Steering Group Report.

In the Draft Report we said that, while the manager's role is primarily operational in nature, the functions it performs on behalf of a fund and its investors are integral to the proper functioning of a fund. Further, we believed that independent oversight of the manager will play a significant role in enhancing the integrity of the mutual fund industry in Canada. We therefore recommended that there be independent oversight of the capital adequacy, personnel proficiency and standards of business practice of mutual fund managers, and that this oversight be conducted by the independent governance agency.

One commenter agreed with our recommendation.[439] Two other commenters disagreed with vesting this responsibility in the independent governance agency.[440] They felt that, at least initially, the independent governance agency would be faced with a steep learning curve, and that formatting appropriate guidelines for complex issues such as capital adequacy and personnel proficiency will require expertise which is more often found in regulators. Additionally, there was concern that adding this responsibility to the independent governance agency would add potential liability to its members, making it even more difficult to attract qualified people. In addition, we note that, if standards for mutual fund managers are left to be established by governance bodies, consistency of standards across the industry will likely suffer.

We continue to believe that there are important reasons for requiring oversight of mutual fund managers; they have been articulated in earlier reports on the mutual fund industry and in the discussion above. In our Draft Report we identified capital adequacy, personnel proficiency and standards of business conduct as matters with respect to which standards for mutual fund managers might be established. There may be others.

We do not offer any conclusions on whether mutual fund managers ought to be "registered." Having concluded, however, that they should be subject to certain minimum standards and that compliance with those standards should be overseen by an appropriate and independent third party, we suggest the following framework for addressing this issue:

1. What standards or requirements should be satisfied by mutual fund managers before they are permitted to establish, promote and run a publicly offered mutual fund?
2. Depending on the answer to question number 1, who is best positioned to establish those standards and requirements, and monitor compliance with them?

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[439] See comment letter of Ontario Teachers' Pension Plan.

[440] See comment letters of Faskin Martineau DuMoulin LLP and Ogilvy Renault.

3. Is registration of mutual fund managers a necessary and justifiable means, from a cost-benefit analysis point of view, of imposing and monitoring compliance with the applicable standards for mutual fund managers?

Recommendation:

We urge regulators and the mutual fund industry to work together to determine what standards or requirements should be satisfied by mutual fund managers before they are permitted to establish, promote and run a publicly offered mutual fund; who is best positioned to establish those standards or requirements and to monitor compliance with them; and whether registration of mutual fund managers is necessary and justifiable, from a cost-benefit point of view, as a means of imposing and monitoring compliance with the applicable standards or requirements for mutual fund managers.

19.8 Rulemaking Authority

As a final matter, we considered whether there is sufficient authority under the Act for the Commission to regulate with respect to fund governance. Subsection 143(31) of the Act states that the Commission may make rules "regulating mutual funds or non-redeemable investment funds and the distribution and trading of the securities of the funds" and enumerates 12 examples of the type of regulation in which the Commission may engage. In the event that the language of subsection 143(31) is not sufficiently broad to cover the mutual fund governance regime we contemplate, then we would support an amendment to confer upon the Commission the necessary authority to address mutual fund governance reform through rulemaking.

Recommendation:

We recommend that subsection 143(31) of the Act be amended, if required, to give the Commission the necessary authority to address mutual fund governance reform through its rulemaking power.

ENFORCEMENT

We considered whether the Commission should have any enforcement powers in addition to those currently in the Act. In particular, we asked whether the Commission should have the power to levy administrative fines and whether the range of public interest orders that the Commission can make should be expanded to include some of the orders that a court can make under section 128 of the Act. We considered these issues in the context of the following framework:

- What New Powers Should the Commission Have?
- Which Existing Powers of the Commission Should Be Expanded?
- Which Existing Powers of the Court Should Be Expanded?
- Other Enforcement Matters: Confidentiality of Investigations, Fraud and Market Manipulation, Insider Trading, Freeze Orders, Investigation Costs, and Whistle-Blower Protection

In the Draft Report, we made a number of recommendations for increased enforcement powers and related amendments to the Act, several of which have since been adopted in the 2002 Amendments.

CHAPTER 20

OVERVIEW

20.1 Introduction

There are a variety of enforcement methods in the Act to assist the Commission in carrying out its statutory mandate. The Commission may:

- prosecute offences under section 122 of the Act;
- exercise its public interest jurisdiction under section 127 of the Act; and
- apply to the court for a declaration of non-compliance and a further order (or orders) of the court under section 128 of the Act.

Section 127 provides the Commission with a "very wide" discretion to intervene in activities related to the Ontario capital markets when it is in the public interest to do so and is the most common method by which the Commission exercises its enforcement powers.[441]

In considering the enforcement-related matters raised in our Issues List and making our recommendations, the Committee has been guided by the following basic principles:

- **Primary Purpose of Enforcement Powers:** As a regulator with a public interest jurisdiction, the Commission exercises its enforcement powers for the primary purposes of providing protection to investors and ensuring fair and efficient capital markets and confidence in their integrity.
- **Meaningful Powers:** It is critical to the fulfilment of its mandate that the Commission be perceived as having meaningful powers that it is prepared to exercise in appropriate cases.
- **Deterrence:** The purpose of an order under section 127 of the Act is "to restrain future conduct that is likely to be prejudicial to the public interest in fair and efficient capital markets."[442]
- **Flexibility:** The Commission should have available to it a sufficiently broad range of remedies so that it has the flexibility to design the appropriate remedy to address the particular circumstances of each case.

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[441] *Committee for the Equal Treatment of Asbestos Minority Shareholders* v. *Ontario (Securities Commission)*, [2001] 2 S.C.R. 132 at para. 39 [hereinafter *Asbestos*].

[442] *Ibid.* per Iacobucci, J. at para. 43.

- **Inter-Jurisdictional Co-operation:** The increasing globalization of the capital markets and rapid development of technology have resulted in a borderless marketplace. It is essential for securities and other regulatory authorities to co-operate in their information gathering, investigations and enforcement efforts.[443] Such co-operation is facilitated where the Commission has effective and meaningful enforcement powers, having regard to national and international standards.

The Committee has also considered the enforcement powers of securities regulators in other provinces and in certain jurisdictions outside of Canada.[444]

20.2 Background: The 1990 Proposals

In 1988, practical and legal deficiencies in the enforcement provisions of the Act prompted a full review of those provisions by the Commission. The proposed amendments to the Act resulting from this review were published for comment in 1990 (the "1990 Proposals").[445] This was the

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[443] *Global Securities Corp. v. British Columbia (Securities Commission)*, [2000] 1 S.C.R. 494.

[444] The Commission's general enforcement powers under the Act are similar to those of the three other major securities commissions in Canada, being the Alberta, British Columbia and Quebec Securities Commissions, but at the time of our review for the Draft Report they were, in some important respects, not as extensive. In formulating the recommendations in the Draft Report, the Committee considered, on a comparative basis, those areas in which one or more of these agencies had powers which the Commission lacked. The Committee also considered the enforcement powers of securities regulators in the U.S., the U.K. and Australia.

[445] *Proposals for Amendments to the Securities Act in the Areas of Investigations, Enforcement and Remedies*, (1990), 13 OSCB 405. The proposals relating to the Commission's enforcement powers included the following:

a) Add a requirement that the Commission apply forthwith to the court to continue a freeze order made by the Commission.

b) Expand the remedial powers of the Commission to provide a wider range of disciplinary and compensatory powers, including powers to order the following: compliance with the Act, regulations and policy statements; compliance with by-laws, rules, regulations, procedures, practices and directives of a self-regulatory organization; amendment to or cessation in the distribution of a wide range of disclosure materials; private or public reprimand of a person (including professional advisers) for misconduct in the marketplace; prohibition of a person (including a professional adviser) who engages in misconduct in the marketplace from holding office in or being a director of or being employed or retained by or in any other way associated with any registrant or reporting issuer; disgorgement; payment of costs associated with an investigation or proceeding before the Commission.

c) Give the Commission broad power to apply to the court for a declaration of non-compliance and give the court power to order compliance and a wide range of other remedies including rescission, compensation for damages, payment of punitive damages, appointment or removal of directors, issuance, cancellation, purchase, exchange or disposition of a security, and prohibition of voting or exchange of any rights attaching to a security.

d) Extend responsibility for a breach of the Act to reach beyond officers and directors, to any person (including a professional adviser) who authorizes, counsels or participates in a breach of the Act, the regulations or the policy statements.

Following the publication for comment of these proposals, the Commission published a draft of the specific proposed changes to the Act ((1991), 14 OSCB 1907). In addition to the matters listed above, this draft included certain additional proposed enforcement powers, including the following:

a) Provision for the court to order a person or company found guilty of an offence under the Act to make compensation or restitution to any other person or company.

b) Power of the Commission to order a person or company who has not complied with Ontario securities law to submit to a review of practices and procedures and institute changes.

c) Power of the Commission to order a person or company who has not complied with Ontario securities law to make restitution to any person or company affected by the non-compliance.

(continued)

first set of proposed revisions to the Commission's enforcement powers in 20 years, and was a response to considerable changes in the capital markets that had taken place in that intervening period. The 1990 Proposals also reflected a move to greater harmonization with investigation and enforcement powers of regulators in other jurisdictions, including British Columbia, Alberta and the U.S.[446]

Although work on the 1990 Proposals began in 1988, amendments to the legislation arising out of the 1990 Proposals were not incorporated into the Act until 1994. Since that time there has been a significant increase in retail investors' participation in the marketplace. The need for securities regulators to have meaningful and effective enforcement powers has never been greater.

20.3 What Powers Do the Commission and the Court Currently Have?

The Commission's general enforcement powers are set out in Part XXII (Enforcement). The Commission may prosecute an offence by commencing quasi-criminal proceedings in the Ontario Court of Justice under section 122. In these circumstances the Commission may seek a penalty consisting of a fine or imprisonment or both. The Commission may also apply to the Superior Court of Justice for an order that may include one or more of the civil enforcement orders listed in subsection 128(3) or for the appointment of a receiver, trustee or liquidator under section 129. In addition, the Commission may commence administrative proceedings under section 127, seeking one or more of the orders provided for under subsection 127(1), which may be made in the public interest.

The provisions in Part XXII deal with:

A) PROSECUTION OF OFFENCES

Section 122 sets out what constitutes an offence under the Act and the penalties for the commission of an offence.

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d) Power to make certain orders in respect of non-compliance with exchange or self-regulatory organization rules or by-laws, etc. (including compliance order and restitution order).

e) Power to make certain orders in the public interest, including the suspension, restriction or termination of registration or recognition, an order that exemptions do not apply and a cease trade order.

f) Power to make certain orders in respect of a professional person or company that has counselled a breach of securities law, assisted in conduct which constitutes a breach or provided an opinion, advice or information to the Commission or staff which is deceptive or misleading.

[446] *Ibid.* at pp. 405 and 407.

B) EXERCISE OF PUBLIC INTEREST JURISDICTION

Section 127 lists the orders that may be made by the Commission, in the public interest. These are:

- an order that a person's or company's registration or recognition under Ontario securities law be suspended, restricted, terminated or be subject to terms and conditions;
- an order that trading in securities by or of a person or company cease;
- an order that any exemptions in Ontario securities law do not apply to a person or company;
- an order that a person resign as a director or officer of an issuer or be prohibited from becoming or acting as a director or officer of an issuer;
- an order that a market participant submit to a review of his, her or its practices and institute such changes as may be ordered by the Commission;
- if there has been non-compliance with Ontario securities law, an order that a release, report, preliminary prospectus, prospectus, return, financial statement, information circular, take-over bid circular, issuer bid circular, offering memorandum, proxy solicitation or any other document be provided or not be provided to a person or company or be amended; and
- an order that a person or company be reprimanded.

When the relevant sections of the 2002 Amendments are proclaimed into force, the Commission will also have the power, if it is in the public interest and if it determines that a person or company has contravened Ontario securities law, to:

- order the person or company to pay an administrative fine, to a maximum of $1,000,000 per contravention; and
- order a person or company to disgorge any profits made as a result of the contravention.

C) INTERIM PRESERVATION OF PROPERTY

Under section 126, the Commission has the authority to make an order for the interim preservation of property (a "freeze" order).

D) PAYMENT OF COSTS

Under section 127.1, the Commission may order a person or company to pay the costs of an investigation, or costs of or related to a hearing.

E) APPLICATION TO COURT

Under section 128, the Commission may apply to the court for a declaration that a person or company has not complied with Ontario securities law. If the court makes such a declaration, it may also make any order it considers appropriate. Subsection 128(3) contains a non-exhaustive list of orders that a court may make.[447]

F) APPOINTMENT OF RECEIVER

Under section 129, the Commission may also apply to the court for the appointment of a receiver, receiver and manager, trustee or liquidator of all or any part of the property of any person or company.

20.4 Constitutional and Policy Considerations with Respect to Powers of the Commission

The Committee has considered which of the court powers under subsection 128(3) of the Act, if any, may properly be conferred upon the Commission. In this regard, we have considered whether there may be any constitutional constraints on the extent to which the Commission's powers might be expanded.[448]

Under the *Constitution Act, 1867,* the provinces have the power to make laws in relation to the administration of justice in the province, including the creation of courts in the province.[449] On the other hand, the judges of the superior, district and county courts in each province are appointed by the Governor General and their salaries are fixed and paid by the federal government.[450] These provisions of the *Constitution Act, 1867* have traditionally been interpreted to prevent provincial governments from conferring "judicial" powers on provincial tribunals on the basis that such powers could only be exercised by federally appointed judges on the superior, district and county courts.[451] This view with respect to powers of provincial tribunals has been liberalized over the years. In particular, courts have recognized the different functions of such tribunals in the context of their respective legislative schemes and developed a broader approach to the analysis of the validity of their powers. The Supreme Court of Canada has articulated a three-step test to determine whether a power conferred on a provincial tribunal violates the division of powers under the *Constitution Act*:[452]

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[447] Included among the listed orders are: an order to comply with Ontario securities law; an order prohibiting a person from acting as an officer or director or prohibiting a person or company from acting as a promoter of any market participant; an order requiring a person or company to compensate or pay restitution to an aggrieved person or company; and an order requiring rectification of any past non-compliance with Ontario securities law.

[448] The Commission, under section 127, currently has the power to make several orders that are the same as or similar to orders which the court may make under subsection 128(3). These are: an order to submit to a review of practices and procedures, an order directing that a particular document be or not be provided to a person or company, or be amended, and an order prohibiting a person from acting as an officer or director of an issuer.

[449] *Constitution Act, 1867* (Canada), subsection 92(14).

[450] *Constitution Act, 1867* (Canada), sections 96 and 100. The purpose of these provisions is to protect the judges' independence.

[451] For example, see the judgment of Lord Atkin in *Toronto Corporation* v. *York Corporation*, [1938] A.C. 414.

1. Does the challenged power broadly conform to the power or jurisdiction exercised by superior, district or county courts at the time of Confederation?
    - If not, then the power may be validly conferred on a tribunal.
    - If it does, then consider question number two.

2. Is the function of the tribunal a judicial function (i.e., is the tribunal concerned with a private dispute that it is asked to adjudicate through the application of a recognized body of rules, in a fair and impartial manner)?
    - If much of the tribunal's activity does not involve settling private disputes between opposing parties, then the answer to this question may be "no." However, if the tribunal is primarily deciding questions of law or adjudicating private disputes, it may be regarded as exercising judicial powers.
    - If the tribunal does exercise such powers, then consider the third question.

3. If the power of the tribunal is exercised in a judicial manner, does its function as a whole, in its entire institutional context, violate section 96?
    - Consider all of the powers of the tribunal. If the judicial power is incidental to the tribunal's administrative powers, then section 96 is not violated. If the judicial or adjudicative function is the sole or central function of the tribunal, the power is invalid.

The Commission's mandate is to regulate the securities industry in a manner that provides effective protection to investors while fostering fair and efficient capital markets and confidence in those markets. The Supreme Court of Canada has recognized the importance of this mandate, as well as the broad discretion of a securities regulator to determine what is in the public interest.[453] It therefore appears likely that the courts would view the exercise by the Commission of one or more of the powers of the court under subsection 128(3) as being incidental to the Commission's administrative powers. However, this issue should be analyzed in the consideration of any proposed new powers for the Commission.

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[452] *Reference re Residential Tenancies Act (N.S.)* (1996), 131 D.L.R. (4th) 609; *Massey-Fergusson Industries Ltd. v. Sask.* (1981), 127 D.L.R. (3d) 513.

[453] *Pezim v. British Columbia (Superintendent of Brokers)* (1994), 114 D.L.R. (4th) 385; *British Columbia (Securities Commission) v. Branch* (1995), 123 D.L.R. (4th) 462.

WHAT NEW POWERS SHOULD THE COMMISSION HAVE?

We approached our analysis based on the principle that the Commission must have flexibility in the range of remedial sanctions it can impose. For example, there may be situations in which the removal of exemptions or a reprimand may not send a sufficiently strong deterrent message. In other cases, the imposition of a cease trade order may not be appropriate, as it may harm innocent shareholders of the issuer. There may be some circumstances where the imposition of an administrative fine would be the most appropriate sanction.

21.1 Administrative Fine

At the time we issued the Draft Report, the Commission did not have the power to order payment of an administrative fine. We recommended that section 127 of the Act be amended to add a new provision authorizing the Commission, if in its opinion it is in the public interest and if it determines that a person or company has contravened Ontario securities law, to make an order requiring the person or company to pay an administrative fine of up to $1,000,000 per contravention. The Government of Ontario adopted this recommendation in the 2002 Amendments. Below, we explain why we made this recommendation.

A) OTHER JURISDICTIONS

The proposed new power of the Commission to impose an administrative fine is consistent with the power of other administrative bodies, including securities regulators in British Columbia, Alberta, Saskatchewan, Manitoba, Quebec and Nova Scotia as well as in the U.K. The SEC also has this power, although it is exercisable in limited situations.[454] The British Columbia, Alberta, Saskatchewan, Manitoba and Nova Scotia Acts empower their respective Commissions to order payment of an administrative fine where they determine that there has been a contravention of their Act, the regulations or a decision (and a written undertaking to the Commission or the Director under the Saskatchewan and Manitoba Acts), and it is in the public interest. Under the Quebec Act, the Commission may impose an administrative fine when it becomes aware of facts establishing a failure to discharge an obligation under that Act or the regulations. Similarly, the provisions in the applicable U.S. and U.K. legislation tie the imposition of an administrative fine to a finding that there has been a contravention. In addition, the TSX (through RS Inc.) and the

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[454] The SEC may impose administrative fines that range from U.S. $5,000 to $100,000 for a natural person and from U.S. $50,000 to $500,000 for any other person, for each violation. This power is limited to the specific proceedings set out in section 21B(a) of the 1934 Act, which are proceedings instituted against persons pursuant to sections 15(b)4, 15(b)6, 15D, 15B, 15C or 17A of the 1934 Act; i.e., regulated entities and securities industry professionals, such as stockbrokers, investment advisers and transfer agents. (These provisions are found in the following sections of the 1934 Act: section 15 – Registration and Regulation of Brokers and Dealers; section 15B – Municipal Securities; section 15C – Government Securities Brokers and Dealers; section 15D – Securities Analysts and Research Reports; and section 17A – National System for Clearance and Settlement of Securities Transactions.)

IDA have the power to impose fines where there has been a violation of the applicable requirements.[455]

B) SCOPE OF ADMINISTRATIVE FINE

Giving the Commission the power to impose an administrative fine will enable it to tailor sanctions to suit the particular circumstances of a case. The administrative fine that the Commission is able to impose should not be viewed merely as a "cost of doing business" or a licensing fee. The more egregious the conduct being sanctioned, the more important it is for the Commission to be able to send a strong signal to the marketplace. In our view, a maximum of $1,000,000 per contravention is sufficient to allow the Commission to send an appropriate deterrent message, having regard to, among other things, the gravity and impact of the conduct under consideration and the nature of the respondents that are the subject of the proceedings.

Different approaches may be taken with respect to the application of administrative fine provisions. For example, fines may be tiered in different ways. This means that individuals may be subject to lower fines than corporate entities and fines may increase depending on the wilfulness of the conduct and the level of harm. We do not think that the administrative fine that may be imposed by the Commission should be tiered. In our view, setting a maximum amount of $1,000,000 per contravention gives the Commission the flexibility to take into account the particular circumstances of each case, including the gravity and impact of the conduct and the nature of the respondent.

Another approach to the application of administrative fine provisions is to specify that the fine applies on a "per contravention" or "per violation" basis. This is the approach taken in the Alberta Act and the one which we recommended in the Draft Report.[456] In our view, where the Commission finds that there have been separate and distinct contraventions of Ontario securities law, the ability to impose a fine with respect to each contravention allows it to match the sanction to the conduct and gives it the flexibility to sanction conduct which may be more egregious, particularly as evidenced by the number of contraventions. The Government of

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[455] The Alberta Securities Commission has the power to impose a maximum administrative fine of $100,000 for an individual and $500,000 for any other person or company, for each contravention of or failure to comply with the Alberta Act. The Manitoba Securities Commission has the power to impose a maximum administrative fine of $100,000 for an individual and $500,000 for any other person or company. The maximum administrative fine that may be imposed by the BCSC was recently increased from $100,000 to $250,000 for individuals and $500,000 for corporations. The Saskatchewan and Nova Scotia Securities Commissions each can order a maximum administrative fine of $100,000. The Saskatchewan Securities Commission may also order that a person or company pay the cost of producing material specified by the Commission to promote knowledge of investment and regulatory matters, up to a maximum of $100,000. The Quebec Securities Commission may impose an administrative fine of up to $1,000,000. The FSA can also impose a fine, with no stated maximum, pursuant to the *Financial Services and Markets Act 2000* (U.K.), 2000, Chapter c.8. Both the IDA and the TSX (through RS Inc.) have the power to impose fines in an amount not exceeding the greater of $1,000,000 (per offence, in the case of the IDA) and an amount equal to three times the pecuniary benefit that accrued to the person as a result of committing a violation.

[456] Alberta Act, subsection 199(1).

Ontario has adopted this recommendation in the administrative fine provision in the 2002 Amendments.[457]

C) CIRCUMSTANCES IN WHICH ADMINISTRATIVE FINES SHOULD BE APPLIED

As is the case for securities regulators in the other Canadian jurisdictions referred to above, we recommended that the Commission's ability to impose an administrative fine should be exercisable only where there has been a contravention of Ontario securities law and it is in the public interest to impose such a fine. We are aware that there are other remedies available to the Commission which do not require there to have been a contravention of securities legislation but rather, simply a finding that the conduct is contrary to the public interest (for example, the revocation of registration). However, we recognize that the imposition of an administrative fine may be viewed as a different kind of remedy from the others currently listed in section 127 of the Act and that principles of natural justice are better served by tying the imposition of an administrative fine to a demonstrated breach of Ontario securities law. The Government of Ontario adopted this recommendation in the 2002 Amendments.[458]

In the Draft Report, we strongly urged the Commission, in any reasons it gives when imposing an administrative fine, to give explicit guidance as to the matters it considered in determining that a fine should be imposed and the quantum of the fine. One commenter suggested that it would be of more assistance to the Commission and those counsel advising clients about sanctions, to have such principles set out in the Act, or at least in the Regulations.[459] We understand that, outside of the comment process, others have also expressed concerns about consistency with respect to sanctions imposed by the Commission. Clearly, the Commission has the discretion to determine what is an appropriate sanction and would have to consider all the relevant circumstances of a case in determining this. However, it would be useful for the Commission to provide some form of guidance, such as a set of principles or guidelines, setting out the considerations that may be taken into account in determining the appropriate sanction to be applied in the context of administrative proceeding.[460] We do not think that this should be limited to considerations that apply in ordering administrative fines, but rather such guidance should cover all sanctions available under section 127.

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[457] 2002 Amendments, subsection 183(1) adds the following paragraph to subsection 127(1) of the Act:

> 9. If a person or company has not complied with Ontario securities law, an order requiring the person or company to pay an administrative penalty of not more than $1,000,000 for each failure to comply.

[458] *Ibid.*

[459] See comment letter of Gowling Lafleur Henderson LLP.

[460] Examples may be found in the FSA and the IDA. Under the *Financial Services and Markets Act 2002 (supra* note 455), the FSA is required to issue statements of policy about the imposition of financial penalties on firms and approved persons. The FSA is requiredto have regard to these statements of policy in exercising, or deciding to exercise, its powers in certain circumstances. These statements of policy are set out in the Enforcement part of the FSA Handbook. In January 2003 the IDA published its "Disciplinary Sanction Guidelines." This document sets out general principles and guidelines prepared by IDA staff that may be taken into account by the District Council when determining the appropriate sanction to be imposed as part of a Settlement Agreement or at the end of a disciplinary proceeding commenced under IDA By-law 20.

D) CONSTITUTIONAL ISSUES

While a number of administrative bodies, including securities regulators, have the power to impose an administrative fine, there may be some risk that an administrative fine of the magnitude recommended by this Committee may be challenged as being penal in nature, thereby having the effect of transforming the administrative nature of Commission proceedings, and possibly triggering constitutional, or even *Charter* concerns.[461]

We are not aware of any decisions in which an administrative fine provided for in securities laws of other jurisdictions in Canada has been found to invoke *Charter* rights. In fact, in two cases in British Columbia, the administrative fine power has withstood challenge.[462] In a British Columbia Supreme Court decision, the court stated that the introduction of administrative fines to the British Columbia Act did not change the whole character of that Act and that it remained a regulatory scheme and was not thereby transformed into a penal statute.[463] In a more recent decision, the British Columbia Court of Appeal also found that the administrative fine provision in the British Columbia Act did not alter the basic character of that Act as regulatory legislation.[464] In its decision, the Court of Appeal referred to the decision of the Supreme Court of Canada in the *Asbestos* case (which addressed the public interest jurisdiction of the Commission under section 127 of the Act). In considering the *Asbestos* decision, the British Columbia Court of Appeal noted that, while there was no administrative fine provision in the Act (in Ontario), such a fine fits within the class of sanctions discussed by Mr. Justice Iacobucci in *Asbestos*, where he stated:

> The enforcement techniques in the Act span a broad spectrum from purely regulatory or administrative sanctions to serious criminal penalties. The administrative sanctions are the most frequently used sanction and are grouped together in subsection 127 as "Orders in the public interest." Such orders are not punitive: *Re Albino* (1991), 14 O.S.C.B. 365. Rather, the purpose of an order under subsection 127 is to restrain future conduct that is likely to be prejudicial to the public interest in fair and efficient capital markets. The role of the OSC under subsection 127 is to

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[461] This issue was considered by the Supreme Court of Canada, albeit in a different context, in *R. v. Wigglesworth*, [1987] 2 S.C.R. 541. In that case an RCMP officer was convicted of assaulting a prisoner under the *Royal Canadian Mounted Police Act* and fined $300 by an RCMP service tribunal. He was subsequently charged with criminal assault for the same incident. The Supreme Court of Canada found that section 11(h) *Charter* rights were not infringed by the dual proceedings. Section 11(h) of the *Charter* describes the right, if found guilty of an offence and punished, not to be tried or punished for it again. In its consideration of the issue, the Court indicated that the possibility of an administrative fine taking on a penal consequence, increases with its magnitude: "In my opinion, a true penal consequence which would attract the application of section 11 is imprisonment or a fine which by its magnitude would appear to be imposed for the purpose of redressing the wrong done to society at large rather than to the maintenance of internal discipline within the limited sphere of activity" (per Wilson, J.).

[462] The BCSC was the first securities commission in Canada to have the authority to impose an administrative fine.

[463] *British Columbia (Securities Commission)* v. *Simonyi-Gindele*, [1992] B.C.J. No. 2893 Vancouver A 921540. (This case did not involve a Charter challenge.)

[464] *Johnson* v. *British Columbia (Securities Commission)*, [2001] B.C.J. No. 2103 (B.C.C.A.).

> protect the public interest by removing from the capital markets those whose past conduct is so abusive as to warrant apprehension of future conduct detrimental to the integrity of the capital markets: *Re Mithras Management Ltd.* (1990), 13 O.S.C.B. 1600. In contradistinction, it is for the courts to punish or remedy past conduct under subsections 122 and 128 of the Act respectively: see D. Johnston and K. Doyle Rockwell, Canadian Securities Regulation (2nd ed. 1998), at pp. 209-11."[465]

We find support in the comments of the British Columbia Court of Appeal for our view that the power in securities legislation to impose an administrative fine is an appropriate administrative sanction.

The majority of the comments that we received on this recommendation in the Draft Report were generally supportive. One commenter thought that the maximum fine should be higher.[466] Some commenters made suggestions as to the structure and application of the administrative fine provision.[467] There were also some commenters who disagreed with our recommendation.[468] The concerns raised by these commenters included that such fines should be imposed by a judge, and that this power may not be constitutionally appropriate for provincial implementation. For the reasons discussed above and in Chapter 20 of this Report, we do not agree.

Recommendation:

We recommend that the Commission provide guidance, in the form of a set of principles or guidelines, setting out the considerations that may be taken into account in determining the appropriate sanction to be applied in the context of administrative proceedings under section 127 of the Act.

21.2 Disgorgement of Profits

There may be cases in which the conduct in question has resulted in a financial gain to the person or company who has contravened Ontario securities law. In such cases, while other sanctions may also be appropriate, it seems inappropriate that such person or company should be able to retain any illegally obtained profits. An order for the disgorgement of such profits would serve to maximize the deterrent effect of the overall sanction.

The SEC has the power to order disgorgement and an accounting, both in the context of a cease and desist proceeding and in the context of an order for the payment of an administrative fine, and has adopted special rules to deal with this.[469] As the primary purpose of such an order is to deprive a wrongdoer of ill-gotten gains, the amount of disgorgement that may be ordered is limited to the amount of the illegal profits.[470] In the Draft Report we recommended that section 127 of the Act be amended to add a new provision authorizing the Commission, if in its opinion it is in the public interest and if it determines that a person or company has contravened Ontario securities law, to make an order requiring the person or company to disgorge any profits made as a result of the contravention. The Government of Ontario adopted our recommendation and included this power in the 2002 Amendments.[471]

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[465] *Asbestos, supra* note 441, at para. 43, quoted in *Johnson, ibid.*

[466] See comment letter of the Ontario New Democratic Party.

[467] See comment letters of Fasken Martineau DuMoulin LLP and Gowling Lafleur Henderson LLP.

[468] See comment letters of the Securities Law Subcommittee of the Ontario Bar Association, Simon Romano and BMO Nesbitt Burns.

21.3 Application of Money Paid as Administrative Fine or Disgorged Profits

We considered how money paid to the Commission as an administrative fine or pursuant to a disgorgement order should be applied. In examining this issue in the Draft Report, we reviewed how the Act deals with monies paid pursuant to a settlement agreement.[472] We also examined on a comparative basis how other provinces treat administrative fines. For this purpose, we would treat monies paid under a negotiated settlement agreement, paid as an administrative fine, or paid pursuant to a disgorgement order in an analogous fashion.

The Commission has the authority under the Act to retain for its own use the fees it charges and revenue generated from the exercise of a power or duty.[473] The Minister of Finance can require the Commission to pay surplus funds that it accumulates into the Consolidated Revenue Fund, if doing so will not impair the capacity of the Commission to meet its financial and contractual commitments. Money received by the Commission as a payment to settle enforcement proceedings must be paid into the Consolidated Revenue Fund unless it is (a) to reimburse the Commission for costs incurred or to be incurred or (b) designated under the terms of the settlement for allocation to or for the benefit of third parties.[474] Designated settlement payments received by the Commission are paid into a separate account and held in trust for the benefit of third parties.

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[469] 1933 Act, clause 8A(e); 1934 Act, clauses 21C(e) and 21B(e); and SEC Rules of Practice – Rules Regarding Disgorgement and Penalty Payments, Rules 600, 601, 610-614, 620 and 630.

[470] The funds recovered by the SEC in such circumstances are typically paid into an escrow account established for the benefit of those injured by the illegal activity. The funds are administered and distributed in accordance with a plan that is submitted by the SEC's Division of Enforcement (unless otherwise ordered). The plan must include procedures for selecting a fund administrator to oversee the fund and process claims, as well as procedures for making and approving claims. The plan must be published for comment and is subject to approval by the SEC or a hearing officer. The fees and expenses of administering the plan are generally paid first from the interest earned on the disgorged funds, and then from the funds themselves. Any undistributed funds may become the property of the U.S. Treasury.

[471] The 2002 Amendments, subsection 183(1) adds the following paragraph to subsection 127(1)of the Act:

> 10. If a person or company has not complied with Ontario securities law, an order requiring a person or company to disgorge to the Commission any amounts obtained as a result of the non-compliance.

[472] We reviewed section 3.4 of the Act as it existed prior to the 2002 Amendments.

[473] The Act, subsection 3.4(1). The money received mustbe applied to carrying out the duties and powers of the Commission.

The provinces take different approaches with respect to the application of administrative fines imposed by securities commissions. Alberta requires that the money received from administrative fines be used for "endeavours or activities that … enhance or may enhance the capital market in Alberta."[475] British Columbia, Quebec and Saskatchewan generally direct that money received from administrative fines be used for the purpose of promoting knowledge of capital market participants (or, specifically, investor education).[476]

As we indicated in the Draft Report, we endorse the approach in the Act for dealing with money received from a negotiated settlement. We support taking the same approach with respect to money received pursuant to an administrative fine or a disgorgement order. It seems sensible to us that where harm has been done to the capital markets or investors have suffered losses, the Commission should have the flexibility to designate that monies paid by a respondent in the context of an enforcement proceeding be allocated for the benefit of third parties. This approach is also consistent with the legislative scheme of several of the other provinces. We are pleased that the Government of Ontario has adopted this recommendation in the 2002 Amendments, with its amended subsection 3.4(2) of the Act.[477]

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[474] The Act, subsection 3.4(2). These provisions were added to the Act in 1997, when the Commission became self-funding. The purpose of the exception in subsection 3.4(2) is to avoid actual or perceived conflicts of interest. Without this provision, it could be argued that the Commission would be in the position to encourage settlements, not because they are in the public interest, but rather to generate additional revenue.

[475] Under subsection 19(5) of the Alberta Act, administrative fines are not to be used for normal operating expenditures of the Commission and must only be used "for endeavours or activities that in the opinion of the Commission enhance or may enhance the capital market in Alberta."

[476] Under subsection 15(3) of the British Columbia Act, money received from administrative fines may be used only "for the purpose of promoting knowledge of participants in the securities markets of the legal, regulatory and ethical standards that govern the operation of the securities market in British Columbia." Under section 273.1 of the Quebec Act, administrative fines are to be paid into a designated fund and "allocated to the education of investors or the promotion of their general interest." Under clause 135.1(2)(b) of the Saskatchewan Act, the Commission has the power to order that a person or company pay the cost of producing material specified by the Commission "to promote knowledge of participants in the capital markets of investment and regulatory matters."

[477] The 2002 Amendments, section 178 repeals subsection 3.4(2) of the Act and substitutes the following:

> (2) The Commission shall pay into the Consolidated Revenue Fund money received by the Commission pursuant to an order under paragraph 9 or 10 of subsection 127(1) of this Act or paragraph 9 or 10 of subsection 60(1) of the *Commodity Futures Act* or as a payment to settle enforcement proceedings commenced by the Commission, other than money,
> (a) to reimburse the Commission for costs incurred or to be incurred by it; or
> (b) that is designated under the terms of the order or settlement for an allocation to or for the benefit of third parties that is approved by the Minister or that belongs to a class of allocations approved by the Minister.

We understand that settlement payments received by the Commission that are allocated to or for the benefit of third parties have historically been used for investor education purposes. While this is an appropriate use for such funds, there are other possible uses, including assisting investors who have been harmed by the contraventions that resulted in a payment to the Commission. We encourage the Commission to consider various ways in which third parties may be benefited, in light of the particular circumstances which gave rise to the settlement payment, administrative fine or disgorged profits. If the Commission determines that it would be appropriate to direct that money allocated to or for the benefit of third parties be used to compensate them for losses incurred by them, the Commission should adopt the SEC model of using a trustee to administer the disgorged funds.[478]

The majority of commenters were supportive of our recommendation to permit the Commission to order disgorgement. However, some commenters disagreed that the Commission should have the power to order disgorgement. One of the concerns identified was that the power gives rise to complex substantive and procedural issues relating to determinations of entitlement and quantum, including rights to participate in proceedings and to appeal determinations.[479] We acknowledged, in the Draft Report, that there may be procedural concerns in connection with the power to order disgorgement of profits, including matters relating to the determination of entitlement to disgorged monies and the extent of such entitlement. We believe these concerns can be overcome and envisage that there will be a need for some mechanism to deal with them. For example, the SEC rules dealing with disgorgement payments include rules dealing with interest on amounts disgorged, the submission of a proposed plan of distribution, the contents of such a plan, giving notice of the plan and opportunity for comment, approving the plan, the administration of the plan, and rights to challenge an order of disgorgement.[480] The Government of Ontario has provided, in the 2002 Amendments, that the Lieutenant Governor in Council have the power to make regulations in respect of the administration and distribution of amounts disgorged pursuant to a disgorgement order made by the Commission.[481] We suggest that consideration be given to whether it would be appropriate for the Commission to have concurrent rule-making authority in this regard. Alternatively, the Commission could rely on its power under the *Statutory Powers Procedure Act* to make rules governing the practice and procedure before it.[482] We note that the 2002 Amendments also include a provision that addresses participation in proceedings in which a disgorgement order may be made, by clarifying that there is no right to participate solely on the basis of having a claim against the respondent or an entitlement to receive any amount disgorged under the order.[483]

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[478] It is interesting to note that section 308(a) of the *Sarbanes-Oxley Act of 2002* provides that where amounts are ordered to be paid by way of disgorgement and the SEC also obtains a civil penalty against a person, the SEC may make a motion or direction to add the amount of the civil penalty to the disgorgement fund.

[479] See comment letter of Fasken Martineau DuMoulin LLP.

[480] SEC Rules of Practice – Rules Regarding Disgorgement and Penalty Payments, *supra* note 469.

[481] The 2002 Amendments, subsection 187(4).

[482] *Statutory Powers Procedure Act*, R.S.O. 1990, c. S. 22, subsection 25.1(1).

Recommendation:

We suggest that consideration be given to whether it would be appropriate for the Commission to have rule-making authority to deal with issues relating to the administration and distribution of money ordered by the Commission to be disgorged.

21.4 Attribution Provision

Prior to the passage of the 2002 Amendments, the Act did not contain a general attribution provision that would make officers, directors and certain other persons liable for a corporation's breach of Ontario securities law if they authorized, permitted or acquiesced in the violation.[484] However, under subsection 122(3) of the Act, every director and officer of a company or of a person other than an individual who authorizes, permits or acquiesces in the commission of an offence under the Act by the company or the person, is guilty of an offence and on conviction is liable to the same maximum fine and imprisonment term as under the general offence provision in subsection 122(1). This applies whether or not a charge has been laid or a finding of guilt has been made against the company or person in respect of the offence.

It is certainly possible that the attribution provision in subsection 122(3) is sufficiently broad to apply to any proceeding brought in connection with an alleged contravention of Ontario securities law. However, it may also be argued that, in light of the reference to the consequences on a conviction in such circumstances, this attribution section is applicable only in the context of a proceeding under section 122 of the Act. One of the commenters on the Committee's recommendation that the Commission have the power to order an administrative fine, expressed the concern that it is not clear, where a corporation has breached Ontario securities law, whether the administrative fine would also apply to officers and directors.[485] We think that it is appropriate for the Act to contain a general attribution section, in order to clarify that the principle expressed in subsection 122(3) should apply in the context of any proceeding dealing with a breach of Ontario securities law and not just those under section 122. The 2002 Amendments include such a provision.[486]

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[483] The 2002 Amendments, subsection 183(2) adds the following subsection to section 127 of the Act:

> (3.1) A person or company is not entitled to participate in a proceeding in which an order may be made under paragraph 10 of subsection (1) solely on the basis that the person or company has a right of action against the respondent to the proceeding or the person or company may be entitled to receive any amount disgorged under the order.

[484] See, for example, section 168.2 of the British Columbia Act, which provides:

> "If a person, other than an individual, contravenes a provision of this Act or of the regulations, or fails to comply with a decision, an employee, officer, director or agent of the person who authorizes, permits or acquiesces in the contravention or non-compliance also contravenes the provision or fails to comply with a decision, as the case may be."

[485] See comment letter of Gowling Lafleur Henderson LLP.

21.5 Breach of Undertaking

In many situations, persons or companies dealing with the Commission "undertake" to the Commission to take certain action. Undertakings may be given in the ordinary course of dealings with the Commission and may be given to the Executive Director, a director or staff, depending on the circumstances. In a prospectus context, for example, undertakings may be given in connection with the filing of documents. In the enforcement context, an undertaking may be used as a term of settlement with respect to a matter that is the subject of an investigation or examination or an enforcement proceeding.

The Commission currently has no specific authority to enforce undertakings. The absence of clear authority in this regard might have an effect on the way in which certain persons view compliance with their undertakings.

The Committee is of the view that undertakings play a meaningful role in the enforcement process by giving the Commission the flexibility to accommodate particular circumstances and to achieve an outcome which may not otherwise be available through administrative proceedings. We also believe it is important that this flexibility be preserved, to the extent possible, in a manner that recognizes the gravity of the circumstances and ensures that an undertaking will be taken seriously. One way of accomplishing this is to make it an offence, under the Act, to breach an undertaking.

The Committee considered provisions under other securities legislation in Canada, which provide that it is an offence to breach an undertaking.[487] Under the Quebec Act, the offence relates to undertakings given to the Quebec Securities Commission, while under the Alberta Act, it relates to written undertakings given to the Commission or the Executive Director, and under the Saskatchewan Act, it relates to written undertakings given to the Commission or the Director. There is no similar provision in the Act. The Committee recommends that the Act be amended to provide that the breach of a written undertaking to the Commission or the Executive Director is an offence. As a result, if such a breach were to occur, the Commission would then be in a position to make an order under section 127, prosecute with respect to the offence under section

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[486] The 2002 Amendments, section 184 amends Part XXII of the Act by adding the following:

> 129.2 For the purposes of this Act, if a company or a person other than an individual has not complied with Ontario securities law, a director or officer of the company or person who authorized, permitted or acquiesced in the non-compliance shall be deemed to also have not complied with Ontario securities law, whether or not any proceeding has been commenced against the company or person under Ontario securities law or any order has been made against the company or person under section 127.

[487] Alberta Act, clause 194(1)(e); Quebec Act, subsection 195(2); and Saskatchewan Act, clause 131(3)(e).

122, or seek an order of the court under section 128 of the Act. The avenue chosen, if any, would depend on the nature and severity of the breach.

One commenter on this recommendation suggested that an undertaking that is subject to the proposed new offence provision should be expressly stated to be such an undertaking.[488] We understand the concern to be that it should be clear that a particular statement is an undertaking and that a breach of that undertaking may be subject to enforcement and sanction. In order to avoid potential misunderstandings in this area, it might be helpful for the Commission to ensure that persons giving written undertakings to the Commission or the Executive Director are made aware that contravening or failing to fulfil such undertakings is an offence.

Recommendation:

We recommend that a new offence be created under section 122 of the Act, for failing to fulfil, or contravening, a written undertaking to the Commission or the Executive Director. We also recommend that the Commission ensure that persons giving written undertakings to the Commission or the Executive Director are made aware that contravening or failing to fulfil such undertakings is an offence.

21.6 Restitution or Compensation Order

The Committee considered whether the Commission should have the power to order that a registrant repay to its clients all or any of the money paid by clients for securities purchased through the registrant where the registrant has engaged in misconduct vis-à-vis such clients.

A) COMMISSION'S AUTHORITY

The Commission has no authority under the Act to make a restitution or compensation order.[489] This is consistent with the objective of regulatory legislation in general and the Commission's public interest jurisdiction, which is protective, not remedial.[490] This is also consistent with the powers of securities commissions and regulatory authorities in all but one of the other provinces and territories in Canada and in the U.S. and Australia, none of which currently has the direct power to order restitution or compensation.

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[488] See comment letter of Davies, Ward, Phillips & Vineberg LLP.

[489] We note that restitution is not the same as disgorgement. Restitution is a remedy that aims to restore a person to the position they would have been in if not for the improper action of another. Disgorgement is an equitable remedy that aims to deprive a wrong-doer of illegally obtained amounts. These amounts may not necessarily be paid to the person who suffered loss, and even if they are so paid, may not be sufficient to return that person to their original position.

[490] *Asbestos*, *supra* note 441. As Iacobucci, J. stated, "[t]he focus of regulatory law is on the protection of societal interests, not punishment of an individual's moral faults" (at para. 42). See also the comments of Laskin, J.A., in the decision of the Ontario Court of Appeal, in *Asbestos*, that "[t]he purpose of the Commission's public interest jurisdiction is neither remedial nor punitive; it is protective and preventative, intended to be exercised to prevent likely future harm to Ontario's capital markets" ((1999), 43 O.R. (3d) 257, at p. 272).

We note, however, that there are two recent examples of regulatory authorities obtaining the power to order restitution:

- The Manitoba Securities Commission has the power, in the course of an administrative hearing, to make an order of compensation for financial loss, up to a maximum of $100,000. The Commission must be able to determine the amount of the financial loss on the evidence and find that the contravention or failure to comply caused the loss in whole or in part. Duplication of proceedings (i.e., a civil claim) is prohibited.[491]
- Under the *Financial Services and Markets Act 2000* in the U.K. the FSA has the direct power to order restitution, in addition to the power to obtain a restitution order from the court.[492]

These developments suggest a shift in the traditional notions that regulatory powers are not remedial. This is an evolving area and while we are of the view that it may not be necessary or appropriate for the Commission to have the power to order restitution at this time, particularly as it will have the power to order disgorgement, we realize that this may change. We recommend that the Commission monitor the exercise of these newly acquired powers in both Manitoba and the U.K., and consider the practical implications of the exercise of this power, before making a determination as to whether the Commission should seek the power to order restitution.

Recommendation:

We recommend that the Commission monitor the exercise by the Manitoba Securities Commission and the FSA of their respective new restitution powers and consider the practical implications of the exercise of this power, with a view to revisiting in the future whether a power to order restitution would be an appropriate remedy for the Commission.

B) AUTHORITY OF THE COURT UNDER SECTION 128

The Commission has the discretion under section 128 of the Act to apply to the court for a declaration that a person has not complied with or is not complying with Ontario securities law. In making such an order, the court may also order a wide range of remedies, including an order for compensation or restitution. We understand that the Commission has only once applied to the court for a restitution or compensation order.[493] We encourage the Commission to consider exercising its discretion under that section to seek an order of the court for restitution or compensation in appropriate cases.

We also suggest that consideration be given to another possible approach. One commenter on the Draft Report proposed as an alternative to a Commission power to order disgorgement, that section 128 of the Act be amended to permit any interested party to bring an application before the court for a restitution order.[494] We think that this suggestion may have merit, but do not believe that the two remedies are mutually exclusive. We recommend that consideration be given to amending section 128 of the Act to permit investors, in certain circumstances, to apply to the court directly for an order for restitution or compensation, not as an alternative, but rather in addition to the disgorgement power under section 127. Of course, where both remedies are used, or potentially available, it will be important to ensure that there is no double recovery.

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[491] The Manitoba Securities Commission's restitution power became effective February 3, 2003.

[492] *Financial Services and Markets Act 2000*, *supra* note 455, section 384.

[493] *Ontario (Securities Commission) v. Sides* (1996), 19 OSCB 2056 (Ontario Court of Justice (General Division)).

Recommendations:

1. We encourage the Commission to consider exercising its discretion, in appropriate cases, to apply to the court under section 128 of the Act for a restitution or compensation order.
2. We recommend that consideration be given to the desirability and implications of amending section 128 of the Act to permit investors, in certain circumstances, to apply to the court directly for an order for restitution or compensation.

21.7 Complaint-Handling and Dispute Resolution

In our Issues List, we asked whether financial services regulators, including SROs, should have the ability to handle consumer complaints through ombudsman or arbitration programs. In the Draft Report, we looked at two systems: complaint-handling, which is a process that results in a non-binding recommendation for the resolution of a dispute; and dispute resolution, which is a process, such as arbitration, that results in a decision that is binding on both parties.

A) NATIONAL COMPLAINT-HANDLING SYSTEM

In the Draft Report, we discussed the "Financial Services OmbudSystem," (now referred to as the "Financial Services OmbudsNetwork"), which had been recently announced. As the OmbudsNetwork was not operational at the time we released the Draft Report, the Committee included recommendations as to essential characteristics for a complaint-handling system for the financial services industry. The financial services industry has now launched the OmbudsNetwork as a national complaint-handling system. The OmbudsNetwork consists of three components which together are consistent with the Committee's recommendations in the Draft Report.

1. *The Centre for Financial Services OmbudsNetwork (CFSO)* – The CFSO provides a single contact point for access to the complaint-handling systems of financial services providers and ensures that complaints are channelled to the appropriate point.[495] The

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[494] See comment letter of Fasken Martineau DuMoulin LLP.

[495] This service was officially launched on November 29, 2002.

CFSO will identify and promote industry best practices and develop standards relating to consumer services and complaint handling. The CFSO will also publish an annual report on the activities of the OmbudsNetwork. This report will include information about the nature and volume of incoming inquiries, referrals, the disposition of inquiries and other indicators of the OmbudsNetwork's performance.

2. *The complaint management procedures at the level of each financial services provider* – All member firms have complaint-handling systems at the firm level. This is the first level of recourse for any consumer complaint or concern. If the consumer is not satisfied with the outcome at this level, they can take the complaint to the appropriate industry-level OmbudService.

3. *The industry-level OmbudServices* – There are three industry level OmbudServices:

   (a) the Ombudsman for Banking Services and Investments (OBSI) (sponsored by the Canadian Bankers Association, IDA, MFDA and IFIC);[496]

   (b) the Canadian Life and Health Insurance OmbudService (CLHIO); and

   (c) the General Insurance OmbudService (GIO).

   Each of these services is run by an independent board composed of a majority of directors who are independent of industry. The industry-level OmbudServices work with the consumer and the financial services provider to produce a report and non-binding recommendations. If appropriate, the OmbudService may recommend restitution or compensation.[497] Names of the financial services providers that do not comply with the recommendations will be published. There is no charge for consumers to use the OmbudService. If a consumer is not satisfied with the outcome at the OmbudService level, they can go to a dispute resolution process such as arbitration or court.

As we indicated in the Draft Report, it is important that this complaint-handling system be transparent, i.e., that the OmbudServices publish statistics relating to the use of their programs and particulars as to the resolution of complaints. We would expect that all of the OmbudServices will function similarly to the OBSI model and, at a minimum, publish statistics relating to the number and nature of complaints against each member, as well as descriptions of the complaints dealt with by the OmbudService.

The Committee commends the industry for the progress it has made in establishing a national complaint-handling system for the financial services industry. We encourage the industry to rigorously monitor the system to ensure that it is working as intended. Following the first year of the system's operation, an independent evaluation should be conducted to assess its success. If the results are positive, the next step should be for the industry to consider establishing a dispute resolution system for the financial services industry on a similar, national basis.

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[496] This expands the role of the former Canadian Banking Ombudsman to include ombudservices for customers of banks, member firms of the IDA, the MFDA and IFIC, and most federally regulated trust and loan companies.

[497] The OBSI can recommend restitution or compensation up to a maximum of $350,000.

In the Draft Report, we also included a recommendation that the Commission make it a condition of recognition of an SRO that it require its members to participate in and be bound by any national complaint-handling system as well as any industry-sponsored dispute resolution program, where applicable, and that members be required to advise customers of the availability of such systems and programs. We continue to recommend this approach.

B) IDA ARBITRATION PROGRAM

In our Draft Report, we noted that the IDA had set up an arbitration program designed to assist clients in the recovery of money from dealers. The arbitration program is available, at the client's option, with respect to claims up to $100,000. Unless the parties otherwise agree, the proceedings are confidential and hearings are in private. The costs of the arbitration are generally shared equally by the parties and each party must bear its own legal and other costs. The advantages of this program are that it is less costly and formal than litigation in the courts and that it gives an investor the opportunity to recover money in a relatively quick fashion. The disadvantages are that it does involve a cost to the investor and may involve an imbalance of power, since the member firm is likely to have more resources than the investor and be in a better position to oppose the claim. In addition, we noted the absence of any statistical reporting by the IDA as to the types or number of cases that go to arbitration, or of the results of arbitration.

In the Draft Report, we indicated our concern about the lack of transparency with respect to the IDA arbitration program and strongly encouraged the IDA and any other SROs that have or may be contemplating similar programs to, at a minimum:

- require that their members advise customers of the availability of the arbitration or a similar program at the commencement of their relationship and at any subsequent point at which a complaint or dispute arises; and
- publish, or otherwise make generally available, statistics relating to the use of such programs, including information as to the member involved in the arbitration, a description of the case, the outcome of the case and the amount of any monetary award made.[498]

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[498] We understand that this is the kind of information that is maintained in a central registration depository in the U.S., which keeps data on the firms and brokers registered with the NASD. This information is made available through NASD Regulation's "Public Disclosure Program."

In its comments on the Draft Report, the IDA pointed out that its By-law 37.2, which has been in place since April 2000, requires that all IDA members provide the IDA alternative dispute resolution brochure to all new clients or whenever a written complaint has been received from a client. IDA By-law 37 was recently amended to reflect the appointment of the OBSI. The amendments mandate IDA members to participate in, co-operate with, and provide their clients with information on, the OBSI.[499]

In response to our recommendation for enhanced transparency in relation to its arbitration program, the IDA undertook, in its comment letter, to develop a reporting format that does not create a disincentive to clients to seek arbitration, and that complies with all federal, provincial and territorial privacy laws. The Committee looks forward to the IDA's implementation of this commitment to enhanced transparency in this important area.

Recommendations:

1. We recommend that, as a condition of its recognition of an SRO, the Commission should require the SRO to require its members to participate in and agree to be bound by any national complaint-handling system that is in place, as well as any industry-sponsored dispute resolution program that may be applicable. We favour transparency in connection with such programs and strongly encourage the publication of statistics relating to the use of the programs as well as particulars concerning the outcomes of cases or the resolution of complaints.

2. We encourage the financial services industry to monitor the national complaint-handling system, in particular in the first year of its operation, to ensure that it is working as intended. Assuming that the system is successfully implemented, we recommend that the financial services industry then consider establishing a dispute resolution system on a similar, national basis.

3. We strongly encourage SROs that have or may be contemplating alternative dispute resolution programs to, at a minimum, require their members to advise customers of the availability of such programs.

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[499] Notice of the Commission approval of these amendments may be found in (2002), 25 O.S.C.B. 7379.

WHICH EXISTING POWERS OF THE COMMISSION SHOULD BE EXPANDED?

22.1 Order Resignation as Director or Officer; Prohibit from Becoming or Acting as Director, Officer, Mutual Fund Manager or Promoter

The Commission currently has the power, under paragraph 127(1)7, to order that a person resign one or more positions that he or she holds as director or officer of an issuer. Under paragraph 127(1)8, the Commission has the power to prohibit a person from becoming or acting as a director or officer of an issuer. The Committee considered:

- whether these powers should remain limited in their application to directors or officers of issuers, or whether they should be expanded to include directors or officers of other market participants, such as registrants and mutual fund managers; and
- whether the power to prohibit a person from becoming or acting as an officer or director should be expanded to include the power to prohibit a person or company from becoming or acting as a promoter or engaging in promotional activities in connection with the purchase or sale of securities of an issuer, and the power to prohibit a person or company from acting as a mutual fund manager.

In the Draft Report, we recommended that the power to order a person to resign or to prohibit a person from becoming or acting as an officer or director of an issuer should be expanded to permit the Commission to order a person to resign or to prohibit a person from becoming or acting as an officer or director of a registrant or as an officer or director of a manager of a mutual fund. Managers of mutual funds are not currently required to be registered and the Commission has no authority to prohibit a person or company from becoming or acting as a mutual fund manager. We also recommended that the Commission have this authority.

The Committee also considered whether the Commission should have the power to make an order prohibiting a person from becoming or acting as a promoter. While this is included as a power of the court, under paragraph 128(3)7 of the Act,[viii] we recommended that the Commission should also have this power, just as it has the power to prohibit a person from becoming or acting as a director or officer of an issuer.

[viii] Pursuant to paragraph 128(3)7 of the Act, the court has the power to make an order prohibiting a person from acting as an officer or director, or prohibiting a person or company from acting as a promoter, of any market participant permanently or for such a period as is specified in the order. The equivalent power of the Commission under paragraph 127(1)8 is limited to the power to order that a person is prohibited from becoming or acting as a director or officer of any issuer and does not include a power to prohibit a person or company from becoming or acting as a promoter.

In considering this issue we focused on the narrow definition of "promoter" in the Act,[501] which is directed mainly at the acts of founding, organizing or substantially reorganizing the business of an issuer. This definition focuses on the promoter's involvement in the formative stage of an issuer's development. Today, however, many issuers engage persons or companies to promote the purchase or sale of the issuer's securities. Where such activity is not related to the founding, organization or substantial reorganization of the business of an issuer, the Commission would have no authority to prohibit someone from carrying out such activity where it is found to be contrary to the public interest. In the Draft Report, we noted that the BCSC has the power to prohibit a person from engaging in this type of activity, which is captured in the definition of "investor relations activities" in the British Columbia Act.[502] The definition of "investor relations activities" in the British Columbia Act does not include providing information in the ordinary course of business to promote the products or services of the issuer or to raise public awareness of the issuer, communications necessary for regulatory compliance, or communications in newspapers, magazines or business publications that are in general circulation. Further, it does not purport to deal with interactions with investors or the public that do not promote or could not be reasonably expected to promote the purchase or sale of securities of the issuer.

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[501] "Promoter" is defined in subsection 1(1) of the Act to mean:
(a) a person or company who, acting alone or in conjunction with one or more other persons, companies or a combination thereof, directly or indirectly, takes the initiative in founding, organizing or substantially reorganizing the business of an issuer, or
(b) a person or company who, in connection with the founding, organizing or substantial reorganizing of the business of an issuer, directly or indirectly, receives in consideration of services or property, or both services and property, 10 per cent or more of any class of securities of the issuer or 10 per cent or more of the proceeds from the sale of any class of securities of a particular issue, but a person or company who receives such securities or proceeds either solely as underwriting commissions or solely in consideration of property shall not be deemed a promoter within the meaning of this definition if such person or company does not otherwise take part in founding, organizing, or substantially reorganizing the business.

[502] "Investor relations activities" is defined in subsection 1(1) of the British Columbia Act to mean: any activities or oral or written communications, by or on behalf of an issuer or security holder of the issuer, that promote or reasonably could be expected to promote the purchase or sale of securities of the issuer, but does not include:
(a) the dissemination of information provided, or records prepared, in the ordinary course of the business of the issuer
  i) to promote the sale of products or services of the issuer, or
  ii) to raise public awareness of the issuer, that cannot reasonably be considered to promote the purchase or sale of securities of the issuer,
(b) activities or communications necessary to comply with the requirements of
  i) this Act or the regulations, or
  ii) the bylaws, rules or other regulatory instruments of a self regulatory body or exchange,
(c) communications by a publisher of, or writer for, a newspaper, news magazine or business or financial publication, that is of general and regular paid circulation, distributed only to subscribers to it for value or to purchasers of it, if
  i) the communication is only through the newspaper, magazine or publication, and
  ii) the publisher or writer receives no commission or other consideration other than for acting in the capacity of publisher or writer, or
(d) activities or communications that may be prescribed for the purpose of this definition.

We considered whether the existing definition of promoter under the Act should be expanded to include securities-related promotional activities. However, we concluded that this would not be appropriate, because we do not think that all of the responsibilities and potential liabilities associated with promoters should necessarily attach to persons or companies engaged in such activities.[503] We went on to recommend that the Act include a definition of touting of securities or promotional activities, similar to the concept captured by the definition of "investor relations activities" in the British Columbia Act, and the Commission have the power to prohibit a person or company from engaging in such activities where conduct contrary to the public interest can be demonstrated.[504]

We have considered our recommendation, in particular in light of the fact that on proclamation of the 2002 Amendments, the Act will include an anti-fraud and market manipulation provision.[505] In our view, this new provision should be sufficiently broad to capture these types of promotional activities that are not in the public interest, and give the Commission the power to sanction such conduct appropriately.

Recommendations:

1. We recommend that paragraph 127(1)7 of the Act be amended to authorize the Commission to order that a person resign one or more positions that the person holds as a director or officer of an issuer, *registrant or manager of a mutual fund.*

2. We recommend that paragraph 127(1)8 of the Act be amended to authorize the Commission to order that:
    - a person be prohibited from becoming or acting as a director or officer of any issuer, *registrant or manager of a mutual fund*; and
    - *a person or company be prohibited from becoming or acting as a manager of a mutual fund or as a promoter.*[506]

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[503] See, for example, sections 58, 61 and 130 of the Act.

[504] One commenter took strong exception to this recommendation. The Canadian Investor Relations Institute (CIRI) stated that the definition of investor relations activities in the British Columbia Act is misguided and that for the Commission to perpetuate this definition is "damaging to the effectiveness of investor relations professionals, to issuers' credibility, and potentially to capital markets." We are sympathetic to the concerns expressed by this commenter regarding the use of the term "investor relations activities" in connection with an activity that may be considered contrary to the public interest. We recognize the role played by investor relations professionals, including through the activities of CIRI, in promoting the integrity of the capital markets and as noted in the Draft Report our recommendation should not be construed as critical of investor relations professionals.

[505] See discussion in Chapter 24.

[506] Amendments are shown in italics.

22.2 Compliance Order

A) POWER TO ENFORCE COMPLIANCE WITH ONTARIO SECURITIES LAW

While the Commission currently has the power to make a number of orders that may be characterized as requiring compliance with the Act, these orders are directed to specific circumstances rather than applying more generally to situations that involve a contravention of Ontario securities law.[507]

A general power to order compliance with Ontario securities law:

- is consistent with the protective and preventative nature of the Commission's role in the exercise of its enforcement powers because it would give the Commission the authority to direct market participants to comply with or cease contravening Ontario securities law;
- would permit the Commission to fashion a remedy that is tailored to a specific situation in circumstances where imposing a more severe sanction may not be appropriate. For example, there may be situations where the suspension of registration or a cease trade order may not be warranted, but it is still appropriate to apply a sanction, with a view to protecting investors and deterring similar conduct. In some cases, a reprimand by itself may not be sufficient or appropriate. A general power to order compliance would give the Commission the flexibility to order a person or company to take certain steps in order to comply with requirements under Ontario securities law, or to cease contravening Ontario securities law;
- would lead to greater harmonization of the Commission's enforcement powers with those of other securities regulators. For example, the British Columbia and Saskatchewan Securities Commissions may each make an order that a person comply with or cease contravening the applicable Act, the regulations, a decision or by-law, rule or other regulatory instrument or policy.[508] The Saskatchewan Securities Commission may also order that a person or company comply with or cease contravening a written undertaking made to the Commission or the Director. The SEC may order a person to cease and desist from committing or causing a violation of a provision under the applicable securities legislation, require a person to comply with applicable provisions, and require future compliance or steps to effect future compliance.[509]

The Commission should have the power to make a general compliance order, similar to the power of the British Columbia and Saskatchewan Securities Commissions. In addition, we recommend that the Commission have the power, similar to that of the SEC, to order a person or company to comply in the future or to take steps to ensure future compliance. This would allow the Commission, where a compliance order is appropriate, to send a clear message as to what is expected in terms of future compliance.[510]

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[507] See powers under the Act: section 104 (power to direct a person or company to comply with or cease contravening Part XX or related regulations); paragraph 127(1)4 (power to order that changes be made to the practices and procedures of a market participant); and paragraph 127(1)5 (power to order that a document or report required to be filed under the Act be provided to a person or company, not be provided to a person or company, or be amended).

[508] British Columbia Act, clause 161(1)(a); and Saskatchewan Act, clause 134(1)(f).

[509] 1933 Act, section 8A; and 1934 Act, section 21C.

B) POWER TO ORDER COMPLIANCE WITH DIRECTION, DECISION, ORDER OR RULING OF RECOGNIZED SELF-REGULATORY ORGANIZATION OR EXCHANGE

The provisions with respect to compliance orders in both the British Columbia and Saskatchewan Acts also authorize the respective securities commissions to order a person or company to comply with or cease contravening a direction, decision, order or ruling made pursuant to a by-law, rule or other regulatory instrument or policy of a recognized SRO or exchange.[511] This extension of the power to order compliance is particularly helpful in assisting these recognized bodies to enforce their self-regulatory powers. We believe that the inclusion of a specific authority in this regard underscores the public interest aspect of compliance with such directions, decisions, orders or rulings. Such a power also reinforces the principle in the Act that the Commission should, subject to an appropriate system of supervision, use the enforcement capability and regulatory expertise of recognized SROs.[512]

All of the commenters on these recommendations in the Draft Report supported them.

Recommendation:

We recommend that a new paragraph be created under subsection 127(1) of the Act, authorizing the Commission to order that a person or company:

- comply with or cease contravening:
    - (i) Ontario securities law; or
    - (ii) a direction, decision, order or ruling made under a by-law, rule or other regulatory Instrument or policy of a recognized SRO or exchange.
- comply in the future or take steps to ensure future compliance with Ontario securities law, or a direction, decision, order or ruling made under a by-law, rule or other regulatory instrument or policy of a recognized SRO or exchange.

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[510] The Commission has a similarly future -oriented authority under paragraph 127(1)4 of the Act, which is the power to order that a market participant submit to a review of their practices and procedures and institute any changes that may be ordered by the Commission.

[511] *Supra* note 508.

[512] The Act, section 2.1.

22.3 Cease Trade

The Commission has the power under section 127 of the Act to make an order (a "cease trade order") that trading in any securities by or of a person or company cease permanently or for a specified period.[513]

The scope of a Commission cease trade order is linked to the definition of "trade," which includes the sale or disposition of securities or acts in furtherance of a sale or disposition of securities. However, the definition of "trade" or "trading" in the Act specifically excludes a purchase of securities.[514] This could result in a person or company subject to a cease trade order purchasing or accumulating securities during the cease trade period. Given the purpose of a cease trade order, this seems an illogical result. In our view, a cease trade order should apply to purchases of securities as well.

In order to ensure that cease trade orders serve their intended purpose, the Committee recommended, in the Draft Report, that paragraph 127(1)2 of the Act should be amended to provide that, for the purposes of a cease trade order, "trading" in any securities includes the purchase of securities. This was generally supported by those who commented on this recommendation.[515]

Recommendation:

We recommend that paragraph 127(1)2 of the Act be amended to expressly provide that "trading" in securities for purposes of that paragraph includes the purchase of securities.

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[513] The Act, paragraph 127(1)2.

[514] Subsection 1(1) of the Act provides that "trade" or "trading" includes: (a) any sale or disposition of a security for valuable consideration, whether the terms of payment be on margin, instalment or otherwise, but does not include a purchase of a security or, except as provided in clause (d), a transfer, pledge or encumbrance of securities for the purpose of giving collateral for a debt made in good faith; (b) any participation as a trader in any transaction in a security through the facilities of any stock exchange or quotation and trade reporting system; (c) any receipt by a registrant of an order to buy or sell a security; (d) any transfer, pledge or encumbrancing of securities of an issuer from the holdings of any person or company or combination of persons or companies described in clause (c) of the definition of "distribution" for the purpose of giving collateral for a debt made in good faith; and (e) any act, advertisement, solicitation, conduct or negotiation directly or indirectly in furtherance of any of the foregoing.

[515] One commenter disagreed. See comment letter of Fasken Martineau DuMoulin LLP.

WHICH EXISTING POWERS OF THE COURT SHOULD BE EXPANDED?

23.1 Maximum Fine and Term of Imprisonment under Section 122 of the Act

In addition to the power under section 127 of the Act to make orders in the public interest, the Commission may also prosecute a contravention of the Act before the court under section 122. Under the general penalty provision applicable to all offences (without taking into account the changes enacted under the 2002 Amendments), on convicting a person under section 122 the court may impose a fine, imprisonment for a term of not more than two years, or both a fine and imprisonment. The maximum fine under section 122 is $1,000,000.[516] In the case of a conviction for contravention of the insider trading or tipping provisions, the maximum fine increases to the greater of $1,000,000 and triple the profit made or loss avoided by the person or company by reason of the contravention.[517]

A) SUBSECTION 122(4) OF THE ACT – "BY REASON OF THE CONTRAVENTION"

Subsection 122(4) of the Act sets out the applicable fine in the case of a conviction for contravention of the insider trading or tipping provisions of the Act. The meaning of the phrase "by reason of the contravention" in subsection 122(4) has recently been called into question in a decision of the Ontario Superior Court.[518] Depending on the disposition of this decision on appeal, it may be necessary to amend section 122 to clarify the language and its intent.

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[516] The Act, subsection 122(1) (prior to the enactment of the 2002 Amendments).

[517] The Act, subsection 122(4) (prior to the enactment of the 2002 Amendments). Subsection 122(4) of the Act provides: "Despite subsection (1) and in addition to any imprisonment imposed under subsection (1), a person or company that is convicted of contravening subsection 76(1), (2) or (3) is liable to a minimum fine equal to the profit made or the loss avoided by the person or company *by reason of the contravention* and a maximum fine equal to the greater of $1 million and the amount equal to triple the amount of the profit made or loss avoided by the person or company *by reason of the contravention*." [Emphasis added.]

[518] *R.* v. *Glen Harvey Harper*, Reasons for Judgment of Roberts, J., released January 7, 2002; leave to appeal granted by the Ontario Court of Appeal, January 14, 2002. In his decision, Roberts, J. found that in order to determine the amount of the fine under subsection 122(4) of the Act, following a conviction for insider trading, it must be shown that the profits made or loss avoided by the respondent were made or avoided "by reason of the contravention" of Ontario securities law. He stated that "[i]t is clear from the wording [of subsection 122(4)] that the Crown must prove more than simple profit or loss incurred in the prohibited trades", and that "[t]he contravention is not simply the result of trades carried out, but is linked to the material facts withheld. There must be evidence of the effect of such suppression of material facts on the market." The Court of Appeal granted leave to appeal on the issue of the application of subsection 122(4), as well as subsections 122(1), (5) and (6), following a conviction for insider trading.

B) MAXIMUM FINE AND TERM OF IMPRISONMENT

In the Draft Report, the Committee considered whether the maximum fine and imprisonment term provisions in section 122 should be increased. In doing so, we looked at similar provisions in securities legislation in other provinces and in the U.S.[519] We also considered the importance of ensuring that the Commission's powers are meaningful and that the penalties sought or imposed by the court and the Commission have a sufficient deterrent effect. We were concerned that the maximum fine and term of imprisonment under section 122 were not sufficient and believed that a higher maximum in each case would be appropriate in relation to conduct that is particularly egregious.

The last change to the general penalty provision under section 122 of the Act was made in 1987. At that time, the fine provision was increased from a maximum of $2,000 for an individual and $25,000 for a corporation, to a general maximum of $1,000,000. The maximum imprisonment term was increased from one year to two years. With the changes in the markets since that time, including the extent to which access to trading has opened up as a result of the Internet and other technological advances, there has been a corresponding increase in the opportunities for conduct that contravenes Ontario securities laws, as well as the number of investors (in particular, retail investors) who may be potential victims of such conduct. The Committee considered these developments in conjunction with the types of offences that have been prosecuted under section 122 as well as the types of sentences that have been imposed in the case of convictions under section 122. We also reviewed the imprisonment terms in securities legislation in certain other jurisdictions, in which the maximum terms range from three years to twenty years.[520]

In our view, the maximum fine under the general penalty provision in the Act should be sufficiently large to be viewed as more than simply a licensing fee, so as to send a clear message that the conduct in question will not be tolerated. We therefore recommended in the Draft Report that the maximum fine under section 122 of the Act be increased from $1,000,000 to $5,000,000 and that this increase also be reflected in the provision for the maximum fine on a conviction for contravention of the insider trading or tipping provisions. Commenters were supportive of these recommendations in the Draft Report and these recommendations were adopted by the Government of Ontario in the 2002 Amendments.[521]

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[519] The general maximum fine is the same ($1,000,000) in the British Columbia Act and the Alberta Act. The Quebec Act contains a range of fines with a general maximum of $1,000,000 for certain specified offences. In the U.S., under the 1934 Act there is a general maximum fine of $5,000,000 for a natural person and $25,000,000 for other than a natural person. (This reflects significant increases brought into effect as a result of the *Sarbanes-Oxley Act of 2002*.)

[520] In the British Columbia Act, the maximum imprisonment term is three years (subsection 155(2)). In the Alberta Act, the maximum imprisonment term is five years less one day (subsection 194(2)). Under the 1933 Act, a person who wilfully violates the provisions of that Act or who wilfully makes an untrue statement in a registration statement that is misleading may face up to five years imprisonment (section 24). Under the 1934 Act, in the case of a wilful violation of a prohibition or requirement in that Act or the making of a false or misleading statement in an application, report or other document required to be filed or in any undertaking in a registration statement, the maximum imprisonment term is 20 years (section 32). (This reflects an increase, effected by the *Sarbanes-Oxley Act of 2002*, from a previous maximum of 10 years.) In the U.K., under the *Financial Services and Markets Act 2000*, *supra*, note 455, the maximum imprisonment term is seven years (section 397 – misleading statements and practices offences).

A review of sentencing decisions in Ontario in cases that have been decided from 1988 (i.e., following the increase in the maximum term of imprisonment provided under section 122 from one to two years) to 1996, indicated an increase in the number of sentences that include an imprisonment term, as compared with the 40-year period prior to 1988.[522] The imprisonment terms imposed in the majority of these cases were under the maximum term of two years. As might be expected, the courts reserve imposition of the maximum term for what would be considered to be the worst conduct in the circumstances.[523] A recent example of a significant imprisonment term imposed under section 122 is the *Wall* case,[524] which involved a husband and wife who were charged with the distribution of and trading in securities contrary to Ontario securities law. In that case, the judge referred to the Reasons for Sentence in the *Sisto Finance* case[525] for the authority that the maximum sentence ought to be reserved for the worst sort of offence by the worst sort of offender.[526]

In view of developments in the marketplace over the past decade, we believe that where the conduct resulting in a conviction under section 122 is deliberate, egregious conduct that has caused serious harm to a significant number of investors, a court should have the flexibility to impose a monetary penalty and a term of imprisonment that adequately reflect the serious nature of the violations and the magnitude of the harm caused.

Having considered the background and principles discussed above, we recommended in the Draft Report that the maximum imprisonment term which may be imposed on conviction for an offence under section 122 of the Act should be increased to a term of five years less one day. This would provide the court with sufficient flexibility to fashion appropriate sentences in serious cases, and to send a significant message of deterrence in such cases. The Government of Ontario adopted this recommendation in the 2002 Amendments.[527]

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[521] The 2002 Amendments, section 181.

[522] David Lang and Tim Moseley, "Emerging Trend Toward Jail Sentences for Securities Act Violations in Ontario," (January 1997).

[523] *Consortium Financial Inc., Consortium Properties Inc. and Pia Williamson*, (1992), 15 OSCB 4091. Ms. Williamson was sentenced to 21 months' imprisonment concurrent on 48 counts and in addition was fined a total of $350,000; *R.* v. *Sisto Finance NV et al.*, Reasons for Sentence – Jasper Naude, Ontario Court (Provincial Division), September 28, 1994. Mr. Naude was sentenced to two years' imprisonment.

[524] *R.* v. *Wall* (2001), 24 OSCB 763. Mr. Wall was given consecutive sentences of 18 and 12 months, for a total of 30 months' imprisonment. Mrs. Wall received consecutive sentences of nine and 13 months, for a total of 22 months' imprisonment.

[525] *Supra* note 523.

[526] More recently, in *R.* v. *117329 Ontario Ltd. and TAC International* (Reasons for Sentence, Ontario Court of Justice, January 25, 2002), the court sentenced one of the respondents, Douglas C. Walker, to 24 months in prison for nine convictions under the Act.

Commenters on the Draft Report were generally supportive of this recommendation. However, one commenter was concerned that a sentence as significant as five years should carry with it the procedural protections that are afforded an accused charged with an indictable offence under the *Criminal Code*, and that such matters should be heard by the Superior Court of Justice, rather than the Ontario Court of Justice.[528] This commenter also raised an issue relating to the significance of five years "less a day."

The Committee recommended a maximum prison term of five years less a day, as this is the maximum that can be imposed without triggering the right to a jury trial under the *Charter*.[529] We do not believe that a jury trial is appropriate for prosecutions under the *Securities Act*. Securities regulatory proceedings can be technical and complex and do not lend themselves well to jury trials.[530] Currently, there is no right to a jury trial in the case of a prosecution under section 122; our recommendation to increase the maximum sentence does not take away any existing right. We also disagree that the right to have a preliminary inquiry should be included in the Act. We have no evidence that the current system is deficient in ensuring fair treatment of a person charged under section 122.

23.2 Proposed Authority to Order Restitution

The Committee is aware that it may be difficult, for many reasons, including time and resource issues, for investors to recover financial losses incurred as a result of the commission of an offence under section 122 of the Act. This concern was raised in a recent decision of the court in connection with a prosecution under section 122. In that case the judge, in sentencing the respondents on their convictions for offences under the Act, noted with regret that the investors who were victims of the improper conduct in that case would have to pursue costly and complex litigation to recover their funds. In his reasons for sentence the judge recommended that the Act or the *Provincial Offences Act* be amended to permit the court hearing a matter under section 122 to order restitution.[531] We agree, and recommended in the Draft Report that section 122 of the Act contain a power for the court to order restitution or compensation. We note that such a provision is found in the Alberta Act.[532] This would serve the important objectives of facilitating reparation for harm done to investors by providing an inexpensive manner of recovering their losses and making the wrongdoer directly responsible for the harm that he or she caused.

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[527] *Supra* note 521.

[528] See comment letter of Gowling Lafleur Henderson LLP. These protections are: the right to have a preliminary inquiry and the right to elect a trial by judge and jury.

[529] Section 11(f) of the *Charter* states:

> "Any person charged with an offence has the right, except in the case of an offence under military law before a military tribunal, to the benefit of a trial by jury where the maximum punishment for the offence is imprisonment for five years or a more severe punishment."

[530] In this regard we note that in the context of a civil proceeding in Ontario, the right of a party under the *Courts of Justice Act*, R.S.O. 1990, c. C. 43, to require a jury trial, is not all encompassing. Under subsection 108(2), claims for certain kinds of relief cannot be tried by a jury. These include claims for an injunction or mandatory order, partition or sale of real property, dissolution of a partnership, foreclosure or redemption of a mortgage, specific performance of a contract, rectification, declaratory relief and other equitable relief. In cases where a jury trial is not excluded, a judge may nevertheless deny the right (on a motion by the other party to strike the jury notice) if it appears, for example, that the case will involve difficult and complex issues of law and large numbers of documents.

We understand that there may be procedural issues in connection with the power to make an order for restitution or compensation. These issues may include such matters as the identification of victims, the determination and proof of victims' losses and the collection of the amounts ordered to be paid. However, these are matters that can be dealt with by the court, in its discretion. The legislation may also deal with the collection of amounts ordered to be paid, for example, by providing that a restitution or compensation order may be enforced in the same manner as a judgment of the superior court.

Several commenters on the Draft Report agreed with our recommendation. One commenter disagreed, stating that this type of order is best left for a subsequent civil proceeding.[533]

Recommendation:

We recommend that section 122 of the Act be amended to include a provision permitting the Ontario Court of Justice to make an order, where appropriate, that the defendant compensate or make restitution to persons who have suffered a loss of property as a result of the commission of an offence by the defendant.

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[531] *R. v. Wall, supra* note 524, at p. 773, where Mr. Justice Douglas stated: "I would further recommend that the Act or the *Provincial Offences Act* be amended so that the issue of restitution, forfeiture and seizure of property could be dealt with by the Court who tries this matter. As I understand it now, and it is conceded as a matter of law, I have no power to order restitution to the victims. Instead, costly, complex civil litigation is going to ensue unless the position of the defendants clearly changes. It ought, in my view, to be within my purview to order their assets seized, their assets sold, and restitution made to the people – having made the findings of fact I have."

[532] Subsection 194(7) of the Alberta Act, provides that:
"If a person or company is guilty of an offence under this section, the court
a) may make an order requiring the person or company to compensate or make restitution to the aggrieved person or company, and
b) may make any other order that the court considers appropriate in the circumstances."

[533] See comment letter of Gowling Lafleur Henderson LLP.

OTHER ENFORCEMENT MATTERS

24.1 Confidentiality under Section 16 of the Act

Section 16 of the Act prohibits a person or company from disclosing the nature or content of an order for an investigation or financial examination except to his or her or its own counsel or pursuant to an order of the Commission authorizing such disclosure.[534] Under section 17, the Commission may make an order for disclosure of information referred to in section 16 where it considers that it would be in the public interest to do so. In response to the request for comments on the Issues List, one commenter suggested that the Committee should review the scope, constitutionality and appropriateness of section 16.[535] We understood the concern to be that this provision in the Act is too restrictive and that, for example, a person could not discuss the existence of an investigation or examination or any other knowledge or involvement he or she may have with respect thereto, with his or her employer, an officer or director of the employer or any other person who is not the person's own counsel. In the Draft Report, we recommended that the Commission issue a policy statement providing some guidance on the scope of section 16. We also invited other suggestions in response to this issue. Two commenters echoed the concerns raised regarding section 16.[536] One of these commenters also suggested that section 17 should be amended to address standing to bring an application for a disclosure order, and to provide an opportunity to be heard if an application is denied.[537]

The Committee considered these concerns and, in particular, whether the provision for confidentiality contained in section 16 is appropriate.

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[534] Section 16 of the Act provides:

(1) Non-disclosure – Except in accordance with section 17, no person or company shall disclose at any time, except to his, her or its counsel,

(a) the nature or content of an order under section 11 or 12; or

(b) the name of any person examined or sought to be examined under section 13, any testimony given under section 13, any information obtained under section 13, the nature or content of any questions asked under section 13, the nature or content of any demands for the production of any document or other thing under section 13, or the fact that any document or other thing was produced under section 13.

(2) Confidentiality – If the Commission issues an order under section 11 or 12, all reports provided under section 15, all testimony given under section 13 and all documents and other things obtained under section 13 relating to the investigation or examination that is the subject of the order are for the exclusive use of the Commission or of such other regulator as the Commission may specify in the order, and shall not be disclosed or produced to any other person or company or in any other proceeding except as permitted under section 17.

[535] See comment letter on the Issues List of Simon Romano.

[536] See comment letters of Simon Romano and Ogilvy Renault.

[537] See comment letter of Ogilvy Renault.

The purpose of section 16 is two fold:

i) It protects the integrity of the investigation process. In the absence of such a provision, the Commission would have no control over the information that may be passed on regarding the investigation, including the fact that an investigation is being conducted. Public knowledge of such a fact or of particulars with respect to an investigation could, among other things:

  - prejudice the reputation of the person or company involved, before a decision is made to proceed with an enforcement proceeding; and
  - result in collusion among witnesses who may discuss their evidence and/or assert blanket defences.

ii) It provides statutory protections to a witness who provides information or documents pursuant to a summons under section 13 of the Act.[538]

In this latter case, for example, an employee may be reluctant to provide information to staff of the Commission on a voluntary basis in the context of an investigation of potential securities violations committed by his or her employer. The employee may only be willing to provide such information pursuant to a summons under section 13. The confidentiality requirements in section 16 and the provisions of section 17 with respect to when disclosure may be authorized provide some comfort to persons who are compelled to provide information in such circumstances.

In our view, the confidentiality provision in section 16 is an important element of the investigation provisions in the Act and serves the above-noted objectives of ensuring the integrity of the investigation process and protecting persons who provide information to the Commission in the course of an investigation. It is therefore important that the Commission be aware of the particular circumstances in which disclosure is sought, in order to be in a position to properly weigh the relevant interests involved, i.e., the public interest in disclosure, against the interest in preserving the confidentiality of the investigatory process. This balancing is contemplated by section 17.

While we are sympathetic to the issues raised in this regard, we are concerned that taking away these important protections under section 16 may not be the appropriate response. We note that parties can make an application under section 17 for an order authorizing the disclosure of the information requested.[539] As we recommended in the Draft Report, it might be helpful for the Commission to issue a policy statement providing interpretive guidance on the scope of the confidentiality provision in section 16 and clarifying the process for making an application under section 17. We believe that such a policy statement should be sufficient to provide the guidance necessary to clarify the process and address the issues raised, including the issue of standing to bring such an application.

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[538] Under section 13 of the Act, an investigator or examiner appointed by the Commission has the power to summon and enforce the attendance of any person and compel him to testify on oath or otherwise, and to summon and compel any person or company to produce documents or other things.

[539] Any person directly affected by a decision under section 17 may appeal the decision to the Divisional Court (the Act, section 9).

Recommendation:

We recommend that the Commission issue a policy statement providing interpretive guidance on the scope of the confidentiality provision in section 16 of the Act and clarifying the process for making an application for disclosure under section 17 of the Act, including the issue of standing to bring such an application.

24.2 The Need for an Anti-Fraud and Market Manipulation Provision

A) FRAUD AND MARKET MANIPULATION

In the Draft Report, we recommended that the Act be amended to expressly prohibit fraud and market manipulation. We noted that the Act did not contain an express prohibition against fraudulent activity or market manipulation, although securities legislation in many other jurisdictions includes fraud and market manipulation as specific contraventions against which securities regulators have the power to act.[540]

Since the Commission does have the authority to deal with such conduct pursuant to its public interest jurisdiction under section 127, we considered in the Draft Report whether it was necessary to have a specific provision addressing such conduct. We concluded that (i) it should not be necessary for the Commission to rely on its public interest jurisdiction with respect to conduct that constitutes a fundamental abuse of the capital markets; and (ii) the prohibition of fraud and market manipulation is so fundamental that it should be enshrined in the Act.[541] This would complement rather than detract from the broad authority of the Commission under section

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[540] Securities legislation in each of British Columbia, Alberta, and Saskatchewan contains express prohibitions against market manipulation (Alberta Act, section 93; British Columbia Act, sections 57 and 57.1; and Saskatchewan Act, section 55.1). The wording of the relevant provisions is similar and makes express reference to any conduct designed to create a false or misleading appearance of market activity or to establish an artificial price for a security. The provisions in the British Columbia and Alberta Acts also expressly prohibit fraud. Securities legislation in both the U.S. and the U.K. contains provisions which prohibit market manipulation. U.S. securities legislation prohibits fraud, the manipulation of the market price of a security, and any misleading trading activity (1933 Act, clause 17(a); and 1934 Act, clause 9(a), clause 10(b), Rule 10 b-5 and clause 15(c)). The U.K. legislation contains a regime for market abuse and makes market manipulation an offence (*Financial Services and Markets Act 2002, supra* note 455, Part VII (sections 118-130) and *Code of Market Conduct*). Prohibitions on market manipulation have also been established by RS Inc. and the IDA (Universal Market Integrity Rules, section 2.2 Manipulative or Deceptive Methods of Trading, and IDA Policy No. 5).

[541] See Chapter 6 of this Report.

127 to exercise its enforcement powers in the public interest. The Government of Ontario adopted our recommendation in the 2002 Amendments.[542]

In connection with the adoption of rules on December 1, 2001, which create a framework for ATSs to operate in Canada, the CSA has created a set of basic common trading rules that would apply across all marketplaces.[543] Part 3 of the Trading Rules contains a provision that prohibits market manipulation and fraudulent activity.[544] In our view, such a provision properly belongs in the Act.[545] When proclaimed in force, the 2002 Amendments will introduce an anti-fraud and market manipulation provision into the Act. Consequently, the Trading Rules will then need to be amended to provide that the anti-fraud and market manipulation rules in the Trading Rules will not apply in Ontario; the provision in the Act will instead apply. This will ensure that in those provinces that have these provisions in their Acts, including Ontario, the anti-fraud and market manipulation rules in the relevant Acts will apply, rather than those set out in the Trading Rules.

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[542] The 2002 Amendments, section 182 amends the Act by adding the following section:

> 126.1 A person or company shall not, directly or indirectly, engage or participate in any act, practice or course of conduct relating to securities or derivatives of securities that the person or company knows or reasonably ought to know,
> (a) results in or contributes to a misleading appearance of trading activity in, or an artificial price for, a security or derivative of a security; or
> (b) perpetrates a fraud on any person or company.

[543] National Instrument 21-101 *Marketplace Operation*, National Instrument 23-101 *Trading Rules*, and OSC Rule 23-501 *Designation as Market Participant* (2001), 24 OSCB 665.

[544] Part 3 of the Trading Rules provides as follows:

> 3.1 Manipulation and Fraud
> (1) A person or company shall not, directly or indirectly, engage in, or participate in any transaction or series of transactions, or method of trading relating to a trade in or acquisition of a security or any act, practice or course of conduct, if the person or company knows, or ought reasonably to know, that the transaction or series of transactions, or method of trading or act, practice or course of conduct
> (a) results in or contributes to a misleading appearance of trading activity in, or an artificial price for, a security or a derivative of that security; or
> (b) perpetrates a fraud on any person or company.
> (2) In Alberta, British Columbia and Saskatchewan, instead of subsection (1), the provisions of the Alberta Act, the British Columbia Act and the Saskatchewan Act, respectively, relating to manipulation and fraud apply.

[545] While the wording of new section 126.1 of the Act (as set out in section 195 of the 2002 Amendments) is similar to wording in clause 10(b) and Rule 10(b)5 under the 1934 Act, it makes reference to "an act, practice or course of conduct relating to securities or derivatives of securities" and is not tied to "a trade in or acquisition of a security," as in the case in the U.S. securities legislation. The importance of having a separate reference to "an act, practice or course of conduct" that is not connected to a trade or acquisition has been underscored by a recent decision of a federal appeals court in the U.S. which involved a broker who sold clients' securities and used the money for himself. The broker was convicted on criminal charges and served almost five years in prison. The SEC sued the broker and the court ruled that he should repay money he had taken from his clients' account. This ruling was reversed by the federal appeals court, whose decision was based on whether the fraud was committed "in connection with the purchase or sale of any security," as required in the U.S. securities legislation. That court ruled that there was nothing to indicate that the sales of the securities were not conducted legitimately; as such, they were incidental to the fraud, and accordingly the broker could not be sued by the SEC for a violation of U.S. securities legislation. The decision was appealed to the U.S. Supreme Court, which reversed the decision and held that the fraud was indeed "in connection with" securities sales. (*SEC* v. *Zandford*, 238 F. 3d 559 (4th Cir. 2001), cert. granted, 70 U.S.L.W. 3091 (U.S. Nov. 9, 2001) (No. 01-147)); reversed and remanded: 535 U.S. 813).

We note that the *Criminal Code* contains prohibitions on certain manipulative and fraudulent practices affecting the public market generally or transactions on stock exchanges.[546] We do not think this prevents including a prohibition on market manipulation and fraud in the Act.[547] The Supreme Court of Canada has upheld duplicative provisions in federal and provincial legislation in a number of cases, including cases involving provisions of the Act, even where such provisions may potentially operate concurrently.[548] Further, to the extent that a breach of the prohibition results in an offence, we do not think it is in "pith and substance" criminal law. The courts have given broad scope to the provincial jurisdiction over securities regulation[549] and have upheld provincial penal sanctions enacted for the purpose of enforcing provincial laws.[550] We note that one of the express purposes of the Act is to "provide protection to investors from unfair, improper *or fraudulent practices*" (emphasis added).[551] In our view, the prohibition against market manipulation and fraud in the Act supports this mandate and fits properly within the overall scheme of securities regulation under the Act.

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[546] Section 380 of the *Criminal Code* provides that:

> (1) Every one who, by deceit, falsehood or other fraudulent means, whether or not it is a false pretence within the meaning of this Act, defrauds the public or any person, whether ascertained or not, of any property, money or valuable security or any service,
>
> (a) is guilty of an indictable offence and liable to a term of imprisonment not exceeding ten years, where the subject-matter of the offence is a testamentary instrument or the value of the subject-matter of the offence exceeds five thousand dollars; or
>
> (b) is guilty
>
> (i) of an indictable offence and liable to imprisonment for a term not exceeding two years, or
>
> (ii) of an offence punishable on summary conviction, where the value of the subject-matter of the offence does not exceed five thousand dollars.
>
> (2) Every one who, by deceit, falsehood or other fraudulent means, whether or not it is a false pretence within the meaning of this Act, with intent to defraud, affects the public market price of stocks, shares, merchandise or anything that is offered for sale to the public is guilty of an indictable offence and liable to imprisonment for a term not exceeding ten years.

Section 382 of the *Criminal Code* provides that:

> Every one who, through the facility of a stock exchange, curb market or other market, with intent to create a false or misleading appearance of active public trading in a security or with intent to create a false or misleading appearance with respect to the market price of a security,
>
> (a) effects a transaction in the security that involves no change in the beneficial ownership thereof,
>
> (b) enters an order for the purchase of the security, knowing that an order of substantially the same size at substantially the same price for the sale of the security has been or will be entered by or for the same or different persons, or
>
> (c) enters an order for the sale of the security, knowing that an order of substantially the same size at substantially the same time and at substantially the same price for the purchase of the security has been or will be entered by or for the same or different persons,
>
> is guilty of an indictable offence and liable to imprisonment for a term not exceeding five years.

[547] But see *R. v. Eurosport Auto Co. Ltd. and Hwang* (2003), 219 D.L.R. (4th) 371 (B.C.S.C.) where the court declared *ultra vires* a provision of the British Columbia *Insurance (Motor Vehicle) Act* and held that "the dominant purpose of the legislation is to create an offence of fraud based on an objective test and to punish those who commit fraud against the ICBC….it is in "pith and substance" criminal legislation….Here the Province has created offences which are not necessary to the support of the program for which they were created" (at pp. 383-384). (This decision has been appealed to the British Columbia Court of Appeal and is set for a hearing on April 7, 2003.)

[548] See *R. v. Smith*, [1960] S.C.R. 776. (Even though it was similar to a provision in the *Criminal Code*, the court held that the Act's offence of providing false information in a prospectus was not in "pith and substance" criminal law, but rather was incidental to the main purpose and aim of the Act, i.e., regulating the securities industry with a view to ensuring that the public is protected from being defrauded); and *Multiple Access Ltd. v. McCutcheon*, [1982] 2 S.C.R. 161. (The court held that mere duplication as between provincial and federal legislation, without actual conflict or contradiction, will not render otherwise valid provincial legislation inoperative.)

[549] Peter Hogg, *Constitutional Law of Canada* ("Hogg"), Carswell, Looseleaf edition, pp. 21-23. *Constitution Act, 1867* subsection 92(13).

[550] Subsection 92(15) of the *Constitution Act, 1867* give the provinces the express ancillary power to impose punishment (by fine, penalty or imprisonment) for purposes of enforcing provincial laws made in relation to any matters coming

All of those who commented on this recommendation in the Draft Report were generally supportive of it.

Recommendation:

We recommend that once the provisions of the 2002 Amendments are proclaimed into force, the CSA amend subsection 3.1(2) of National Instrument 23-101 *Trading Rules* to provide that the anti-fraud and market manipulation provisions in the Act will apply in Ontario.

B) MISREPRESENTATIONS

Securities legislation in British Columbia, Alberta, Saskatchewan and Manitoba contains provisions that prohibit a person or company, with the intention of effecting a trade in a security or an exchange contract, from making a statement that they know or ought reasonably to know is a misrepresentation[552] or is false, misleading or deceptive in a material manner.[553] In the Draft Report, we recommended that the Act contain a similar prohibition. The Government of Ontario adopted this recommendation in the 2002 Amendments.[554] We also recommended that this provision apply to any statements, whether written or oral. However, we noted that the provisions in the securities legislation in British Columbia, Alberta, Saskatchewan and Manitoba are directed at misrepresentations made "with the intent of effecting a trade" in a security or contract, which qualification circumscribes the ambit of the prohibition. We therefore questioned the appropriateness of this qualification in the Draft Report. The majority of the

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within the classes set out in section 92. This power requires the courts to "draw a distinction between a valid provincial law with an ancillary penalty and a provincial law which is invalid as being in pith and substance a criminal law….The dominant tendency of the case law has been to uphold provincial penal legislation" (Hogg, at pp. 18-30).

[551] The Act, section 1.1. Section 2.1 of the Act outlines the fundamental principles the Commission should consider and balance in pursuing the purposes of the Act. Included in this list of principles is the following: "The primary means for achieving the purposes of this Act are: (i) requirements for timely, accurate and efficient disclosure of information; (ii) restrictions on fraudulent and unfair market practices and procedures; and (iii) requirements for the maintenance of high standards of fitness and business conduct to ensure honest and responsible conduct by market participants".

[552] Alberta Act, clause 92(3)(c); British Columbia Act, clause 50(1)(d); and Saskatchewan Act, subsection 44(3.1).

[553] *The Commodity Futures Act*, S.M. 1996, c. 73, clauses 49(2)(b) and (c).

[554] The 2002 Amendments, section 182 amends the Act by adding the following section:

> 126.2 A person or company shall not make a statement that the person or company knows or ought reasonably to know,
>
> (a) in a material respect and at the time and in light of the circumstances under which it is made, is misleading or untrue or does not state a fact that is required to be stated or that is necessary to make the statement not misleading; and
>
> (b) significantly affects, or will reasonably be expected to have a significant effect on, the market price or value of a security.

commenters who addressed this issue agreed that the prohibition should not be limited to statements made "with the intent of effecting a trade."[555] We note that the new provision in the 2002 Amendments is drafted in a manner which is consistent with these views.

The Draft Report did not contain suggested language for the recommended prohibition. In the absence of specific language, one commenter raised a concern with the potential breadth of the prohibition.[556] We believe that the provision recently added to the Act in the 2002 Amendments to deal with misrepresentations addresses this concern.

24.3 Insider Trading

The Act contains a prohibition against trading and tipping activity by persons or companies that are in a "special relationship" with a reporting issuer, and requires insiders to report their trading activity. Specifically, the Act prohibits:

- trading of securities of a reporting issuer by persons or companies in a special relationship with the reporting issuer who have knowledge of a material fact or material change with respect to the reporting issuer before it has been generally disclosed ("insider trading"); and
- sharing of information with respect to a material fact or material change, where such information has not been generally disclosed ("tipping").

A person or company in a special relationship with a reporting issuer includes a person or company that is an "insider" of the reporting issuer. Insiders (which include directors or senior officers of the reporting issuer)[557] are required to file a report when they become an insider and when there is any change in their ownership or control over securities of the reporting issuer.[558]

In our Draft Report, we referred to comments we received on the Issues List and noted that the main concerns in connection with insider trading appear to relate to reporting and transparency of reporting and the amount of emphasis which should be placed by the Commission on surveillance and enforcement of insider trading prohibitions.

We believe that we have addressed enforcement issues, generally, through our recommendations in the Draft Report relating to additional enforcement powers of the Commission. Several of these recommendations have been adopted in the 2002 Amendments. These, and certain other of our recommendations, if implemented, will equip the Commission and the courts to better deal with insider trading contraventions. For example:

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[555] See comment letters of Ontario Teachers' Pension Plan, Ogilvy Renault and Torys LLP.

[556] See comment letter of Davies, Ward, Phillips & Vineberg LLP.

[557] The Act, subsection 1(1), definition of "insider."

[558] The Act, sections 107, 108 and 109.

- Pursuant to the 2002 Amendments, the Commission would have the power, under section 127 of the Act, to impose an administrative fine of up to $1,000,000.[559]
- Pursuant to the 2002 Amendments, the maximum fine provided for under section 122 of the Act would be increased from $1,000,000 to $5,000,000 (with a corresponding increase in connection with insider trading convictions) and the maximum term of imprisonment provided for under section 122 would be increased from two years to five years less one day.[560] The potential for a significant fine and term of imprisonment will add to the deterrent effect of the application of the Commission's enforcement powers to insider trading contraventions.
- We have recommended that the Commission have the power to order that a person comply with or cease contravening Ontario securities law and comply in the future or take steps to ensure future compliance. This power could be used by the Commission to supplement other orders it may make in the context of administrative hearings under section 127 of the Act in connection with insider trading contraventions.

We also note that there are several enforcement avenues available to the Commission for alleged insider trading violations. It can commence a quasi-criminal proceeding under section 122 of the Act. It can also commence administrative proceedings before the Commission in which the Commission may, under section 127, make one or more orders in the public interest. Finally, the Commission may apply to the Superior Court of Justice for one or more civil enforcement orders. Traditionally, the Commission has pursued alleged insider trading violations as quasi-criminal offences. We note, however, that a section 122 proceeding is subject to a higher standard of proof (i.e., proof beyond a reasonable doubt versus proof on a balance of probabilities) and a more onerous evidentiary burden. As a practical matter, we suggested in the Draft Report that, in appropriate cases, the Commission consider pursuing these alternative enforcement mechanisms available under sections 127 and 128 of the Act as a regulatory response to illegal insider trading.

One commenter was concerned that our recommendation implicitly suggested that Commission proceedings should be brought for the "weaker" cases.[561] This was not our intention; we do not believe that "weak" cases should be brought. However, we encourage the Commission to take advantage of the remedial variety and flexibility in the Act in choosing the enforcement method that best achieves the objectives of the Act in the particular circumstances.[562]

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[559] The 2002 Amendments, subsection 183(1).

[560] The 2002 Amendments, section 181.

[561] See comment letter of Davies, Ward, Phillips & Vineberg LLP.

[562] We note that the Commission recently issued a Notice of Hearing in the ATI Technologies Inc. matter, which is an insider trading case. In addition to the various orders sought under section 127 of the Act, the Notice indicates that if the Commission finds that any of the Respondents have not complied with Ontario securities law, staff will request the Commission to consider whether an application should be made to the court under section 128 of the Act for a

Finally, we examined the insider trading civil liability provisions of the Act. The Act only confers a cause of action for improper insider trading on persons who purchase or sell securities from or to the offending insider trader (privity requirement).[563] One practitioner has stated that:

> [i]n an active secondary market, it will usually be difficult for an investor to demonstrate the direct relationship required by the statute. More importantly, even if an investor can show the necessary link, the link itself will be no more than a matter of happenstance. The investor who is entitled to recover is no different than other investors trading on the same side of the market at approximately the same time, whose shares are not fortuitously purchased or sold by the insider. The current legislative provisions thus create an unrealistic remedy that even when available, is based on arbitrary distinctions resulting from mere chance.[564]

In the Draft Report, we recommended that the CSA consider as part of its proposed Civil Liability Amendments whether it would be desirable to broaden existing insider trading civil liability provisions by deleting the privity requirement.[565] Two commenters disagreed with this recommendation and provided well-reasoned arguments in support of their position. Among other issues, they pointed out the potential for unfair, excessive damages awards that could arise where the privity requirement is deleted.[566]

U.S. securities law does not contain a privity requirement in connection with the statutory right of action for insider trading. Instead it creates a right of action in favour of contemporaneous traders[567] and limits the total amount of damages that may be imposed, to the profit gained or loss avoided by the insider in the subject transactions. In addition, the total damages that may be imposed against an insider must be reduced by the amount of any disgorgement order made in a proceeding relating to the same transaction or transactions. A similar, principled approach should be adopted in Ontario. In our view, the scheme for civil liability for insider trading should be based on a model of deterrence, rather than providing a compensatory scheme. An insider who trades with knowledge of undisclosed material information should be prevented from enjoying the benefits of such a trade. This can be achieved by:

- deleting the privity requirement and thereby providing a meaningful right of action; and
- limiting the total liability for damages to the amount of profit gained or loss avoided by the insider.

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declaration of non-compliance and a disgorgement order (Notice of Hearing, ATI Technologies Inc. *et al.*, January 16, 2002).

[563] The Act, section 134 ("liable to compensate the seller or purchaser of the securities").

[564] See the dissenting statement of Philip Anisman, TSE Committee on Corporate Disclosure, *Final Report, Responsible Corporate Disclosure – A Search for Balance* (March 1997) at page 112.

[565] The Civil Liability Amendments will be added to the Act (under the 2002 Amendments, section 185).

[566] See comment letters of Fasken Martineau DuMoulin LLP and Ogilvy Renault.

[567] 1934 Act, section 20A(a) provides:

> "Any person who violates any provision of this chapter or the rules or regulations thereunder by purchasing or selling a security while in possession of material, non-public information shall be liable in an action…to any person who, contemporaneously with the purchase or sale of securities that is the subject of such violation, has purchased…or sold…securities of the same class."

We recommend that the Government of Ontario consider amending section 134 of the Act to broaden the insider trading civil liability provisions, as discussed above.

Recommendations:

1. We recommend that, in appropriate cases, the Commission consider pursuing alternative enforcement mechanisms available under sections 127 and 128 of the Act as a regulatory response to illegal insider trading.
2. We recommend that the Government of Ontario consider amending the Act to broaden existing insider trading civil liability provisions by deleting the privity requirement in section 134 of the Act. We further recommend that consideration be given to including a provision that limits liability under this section to the amount of profit gained or loss avoided by the insider as a result of the transaction or transactions in question. Any such liability should also be reduced by the amount required to be disgorged pursuant to an order by the court, or the Commission, if applicable, in a proceeding relating to the same transaction or transactions.

24.4 Insider Reporting

With respect to insider reporting, we note that the CSA has developed SEDI.[568] The objective of SEDI is to allow insiders of most reporting issuers to securely file insider reports in electronic format over the Internet. For the investing public, the new system will make selected data on insiders available to them through the SEDI website. It is anticipated that the implementation of SEDI will result in faster and more efficient dissemination of reported information. SEDI will also facilitate, among regulators, a co-ordinated approach to reviewing insider reports and will provide an ability to effectively monitor compliance with insider reporting requirements.[569] At present, insider reports are required to be filed within 10 days of the date of the trade. Once SEDI is fully operational the CSA should consider further reducing the time period for filing insider reports from the current 10 days. Electronic filings should facilitate more current timely disclosure of insider trades.

In the Draft Report we referred to commenters on the Issues List who expressed concern with respect to transactions through which insiders effectively "dispose" of their securities in an issuer, without triggering insider reporting obligations.[570] Examples provided by these commenters include lending or derivative arrangements and the use of structured financial products, which enable insiders to trade their securities "synthetically" or through a third party.

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[568] Notice of National Instrument 55-102, Forms 55-102F1, 55-102F2, 55-102F3, 55-102F4, 55-102F5 and 55-106 F6, Companion Policy 55-102CP – *System for Electronic Data on Insiders (SEDI)* (2001), 24 OSCB 4414. The SEDI system is currently unavailable due to technical difficulties.

[569] *Ibid*.

[570] See comment letters on the Issues List of the IDA, Simon Romano, and Ontario Teachers' Pension Plan.

in the context of a hedging transaction, without being required to report the transaction in all circumstances. We noted that the SEDI reporting form for insider transactions (Form 55-102F2) specifically requests information with respect to transactions in third-party derivatives. This information is not specifically identified in the existing paper form of the insider report. We are advised that this has caused some confusion in the marketplace and has been misconstrued as a new reporting requirement. We understand that the CSA's intention was to facilitate insider reporting of trades in exchange-traded or over-the-counter options or other derivatives, where reporting of such trades is already mandated by securities legislation.

The Committee is aware that issues have arisen in connection with transactions involving third-party derivatives and whether these must be reported. An example of this would be equity monetizations.[571] Equity monetization transactions give rise to regulatory issues in the context of insider reporting, insider trading, escrow and hold periods. The CSA recently published for comment Multilateral Instrument 55-103 *Insider Reporting for Certain Derivative Transactions (Equity Monetization)*, which proposes to deal with these issues.[572]

As we indicated in the Draft Report, we believe that insiders should be required to report these types of transactions, so that the public may be made aware of the extent of the insider's economic exposure to the issuer and any effective change in, or disposition of, this exposure. We encourage the work of the CSA and emphasize the need for transparency of insider reporting in this regard. We also stress the importance of dealing with these issues on a national basis. A number of commenters on the Draft Report agreed with our recommendation in this regard.

Recommendations:

1. We recommend that the CSA consider further reducing the time period for filing insider reports (from the current requirement to file within 10 days of the date of the trade) once SEDI is operational.

2. We recommend that Ontario securities law be amended to require insiders to report any effective change in, or disposition of, their economic interest in an issuer.

24.5 Freeze Orders

The Commission's power to make a freeze order is set out in section 126 of the Act.[573] This allows the Commission to direct someone who has possession or control of funds, securities or

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[571] An equity monetization is a transaction through which a security holder is put into an economic position which is similar to that of having sold the subject securities, without actually selling them, or triggering an obligation to report a trade.

[572] (2003), 26 OSCB 1805.

[573] The Act, subsection 126(1) provides:
If the Commission considers it expedient,

(continued)

property of any person or company to retain them until the Commission or the court orders otherwise. Such an order may be made without notice. However, under subsection 126(5) the Commission is required to apply to the court for an order continuing its order. This application must be made no later than seven days after the Commission's order is issued.

Following the publication of the Draft Report, Commission staff raised with the Committee a concern relating to subsection 126(5). They pointed out that securities legislation in several of the other provinces does not contain a similar requirement for court review of a freeze order,[574] and suggested that the Act should be amended to permit the Commission itself to consider whether it would be in the public interest to extend the freeze order, pursuant to an application on notice to affected parties. The Committee also reviewed a recent decision of the Superior Court of Justice that addresses the question of what is the appropriate test to be applied by the court in determining whether to continue a freeze order made by the Commission.[575]

We believe that this is an area that would require analysis and public input. In particular, issues to be examined would include whether the court or the Commission is the appropriate entity to continue the freeze order and whether a more appropriate test could be articulated for inclusion in the Act as the basis for continuance of a freeze order. We trust there are other issues to be debated. We recommend that these issues be considered with the benefit of public input and make no specific recommendation at this time.

(a) for the due administration of Ontario securities law or the regulation of the capital markets in Ontario; or
(b) to assist in the due administration of the securities laws or the regulation of the capital markets in another jurisdiction,

the Commission may direct a person or company having on deposit or under its control or for safekeeping any funds, securities or property of any person or company to retain those funds, securities or property and to hold them until the Commission in writing revokes the direction or consents to release a particular fund, security or property from the direction, or until the Ontario Court (General Division) orders otherwise.

[574] The British Columbia, Alberta and Quebec Acts do not require their respective Commissions to seek court review of a freeze order. However, they do require, at a minimum, that an investigation be proposed or ongoing as the basis for making a freeze order. The British Columbia and Alberta Acts also contain alternative bases for making a freeze order, including the proposed or actual institution of Commission or criminal proceedings, the making of certain orders by the Commission, and a failure to comply with (British Columbia) or evidence of a contravention of (Alberta) the securities laws. In the U.S., the SEC may make a temporary cease and desist order (which may include an order to take action to prevent dissipation or conversion of assets) if it determines that an alleged or threatened violation is likely to result in a significant dissipation or conversion of assets, significant harm to investors, or substantial harm to the public interest prior to the completion of the proceedings. A respondent may apply to the SEC or the court to have such an order set aside, limited or suspended. The SEC may also apply to the court for an injunction or a temporary freeze order in certain circumstances. In Ontario, in contrast, subsection 126(1) of the Act (*supra* note 573) is much broader and does not specifically require that an investigation or proceeding be proposed or ongoing, that there be a contravention or evidence of a contravention of Ontario securities law, or that there be a likelihood of dissipation of assets or harm to investors or the public interest, as a basis for making a freeze order.

[575] *Ontario Securities Commission* v. *RBC Dominion Securities Inc.* (2001), 54 O.R. (3d) 767. The court commented on the fact that the Act does not set out a test for these purposes, considered a number of different possible approaches, and ultimately applied a modified form of the test used for a common law Mareva injunction.

Recommendation:

We recommend that the issues raised with respect to the continuation of freeze orders under section 126 of the Act be studied further with the benefit of public input. In particular, we suggest the following issues, at a minimum, would require consideration:

- whether the Commission or the court should authorize the continuation of a freeze order; and
- what is the appropriate test to be applied in determining whether to continue a freeze order.

24.6 Costs Orders

One commenter on the Draft Report raised the issue of the provisions of the Act dealing with investigation costs and suggested that these should be amended (i) to clarify that an unsuccessful respondent is only accountable for actual provable costs and disbursements by Commission staff and (ii) to provide that such costs be subject to assessment by a respondent.[576] The commenter also suggested that the Act should be amended to give the Commission the discretion to award costs on an appropriate scale to successful respondents.

The costs provisions in section 127.1 were added to the Act in 1999. The provisions in section 127.1 authorize the Commission to order a person or company to pay the costs of an investigation, or the costs of a hearing in certain circumstances.[577] Costs paid to the Commission under this section may be retained by the Commission and are not required to be paid into the Consolidated Revenue Fund.[578]

We have some concerns about costs orders under the Act. Clearly, the authority to order payment of costs under the Act is discretionary. However, we believe it would be helpful for the Commission to develop policies or guidelines regarding how costs should be established and in what circumstances they may be ordered. We also think that the costs should be subject to assessment on the application of a respondent.[579]

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[576] See comment letter of Fasken Martineau DuMoulin LLP.

[577] The Commission must be satisfied that the person or company has not complied with Ontario securities law or that they have not acted in the public interest. In addition, where a person or company is guilty of an offence under the Act, the Commission may order the person or company to pay the costs of any investigation carried out in respect of that offence.

[578] The Act, subsection 3.4(2).

[579] A similar approach may be found in the British Columbia and Quebec Acts. Under the British Columbia Act, if a person is ordered to pay costs (as provided under that Act) they may apply to a master or registrar of the Supreme Court to review the order (section 179). The master or registrar may vary the total amount of the fees and charges, within any limits that may be set out in the regulations, after considering all the circumstances, including (a) the complexity, difficulty or novelty of the issues involved; (b) the skill, specialized knowledge and responsibility required of the person or persons who conducted the examination, review, investigation, inspection or hearing; (c) the total amount of fees and charges set out in the order; and (d) the time reasonably expended. The Supreme Court rules

We note that section 127.1 contemplates costs orders in only one direction, i.e., costs to be payable by a respondent to the Commission. There is no "mirror" provision for costs to be payable by the Commission to a respondent. Some, including the commenter referred to above, have argued that the power to order costs should apply both ways; that is, if the Commission has the power to order costs payable by a respondent, it should also have the power to order costs payable to a respondent. We recommend that consideration be given, on any future review of the Act, to whether the Act should include a provision authorizing the Commission to order costs payable to a respondent in Commission proceedings and if so, in what circumstances it should apply.[580]

Recommendations:

1. With respect to the current power to order costs under section 127.1 of the Act, we recommend that the Commission develop policies or guidelines regarding how costs should be established and in what circumstances they may be ordered. We also recommend that costs orders made under section 127.1 should be subject to assessment on the application of a respondent.

2. We recommend that consideration be given, on any future review of the Act, to whether it would be appropriate for the Commission to have the discretion to order costs payable to a respondent in Commission proceedings, and, if so, in what circumstances.

24.7 Whistle-Blower Protection

The need for whistle-blower protection in the Act was raised by one commenter who suggested that the Act should be amended to protect employees who inform authorities of reasonably suspected violations of the Act by their employers or persons associated with them, from retaliation, discipline or discrimination.[581] This comment was raised in light of the *Sarbanes-*

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relating to taxation of costs apply to a review under section 179. In the case of a person convicted of an offence under the British Columbia Act, the Executive Director may prepare a certificate setting out the costs of the investigation of the offence and may apply to a master or registrar of the court to review the certificate, as if it were a bill of costs. After the certificate is reviewed, it may be filed in the court and enforced as if it were an order of the court (section 160). Under the Quebec Act, if a person is found guilty of an offence under that Act or the securities legislation of another authority, the Commission may recover its costs of the investigation from that person, according to the tariff established by regulation (section 212). The Commission is required to prepare a statement of costs and present it to a judge for taxation.

[580] The *Statutory Powers Procedure Act*, R.S.O. 1990, c. S. 22 (SPPA) contemplates that a tribunal may make rules regarding the circumstances in which it may order a party to pay all or part of another party's costs. However, it also provides that such an order may only be made in limited circumstances, i.e., where the conduct of a party has been unreasonable, frivolous or vexatious or a party has acted in bad faith (subsections 17.1(1) and (2)). Although the Commission's current power to order costs under section 127.1 of the Act is broader than subsections 17.1(1) and (2) of the SPPA, it is protected, in effect, by the operation of subsection 17.1(4), which provides that a tribunal may order costs in circumstances other than those set out in subsections 17.1(1) and (2) if it makes the order under provisions of an Act that are in force on the day that section 17.1 of the SPPA came into force. (Section 127.1 of the Act came into force before section 17.1 of the SPPA.) However, in determining whether it is appropriate for the Commission to have the discretion to order costs payable to a respondent in Commission proceedings, it may be important to consider the framework established by the SPPA.

[581] See comment letter of Ontario Teachers' Pension Plan.

Oxley Act of 2002 amendments in the U.S. and in particular section 806 of that Act, which provides protection against employment termination or other retaliatory action for any employee, contractor, subcontractor or agent of a public company who (i) provides evidence regarding conduct that the employee reasonably believes violates federal securities or anti-fraud laws; or (ii) testifies or participates in, or files, a securities or anti-fraud proceeding.[582]

Recommendation:

We support whistle-blower protection in principle, but note that it does not necessarily belong in the Act. Such provisions might more appropriately be included in corporate or employment-related legislation, for example.

24.8 Federal Enforcement Initiatives – One Further Step

This Report contains an extensive discussion of the Commission's enforcement powers, and we have made numerous recommendations for strengthening those powers. We have done so because we believe that effective enforcement powers are critical to the fulfilment of the Commission's mandate.

The Government of Ontario has already adopted a number of the recommendations in our Draft Report relating to enforcement matters. In doing so, the Government of Ontario has shown its recognition and support for the role of enforcement in protecting investors and in fostering the integrity of Ontario's capital markets.

The federal government has also recognized the importance of enforcement efforts in supporting investor confidence. In its February 18, 2003 budget the federal government unveiled plans for a national enforcement approach to strengthen the investigation and prosecution of corporate frauds and market illegalities. The federal government plans to introduce new legislation to "modernize" these offences, to permit targeted evidence-gathering and to tailor sentencing structures to signal the seriousness of corporate fraud offences. The federal government will establish integrated teams of investigators, forensic accountants and lawyers under the joint management of the Royal Canadian Mounted Police and partner agencies, in key financial centers in Canada, to work closely with securities regulators, local and provincial police to pursue the most serious cases of corporate fraud and market illegality (including alleged violations of provincial securities legislation). In addition, the federal government indicated that it will explore with the provinces and other key stakeholders the establishment of concurrent jurisdiction to prosecute serious criminal securities and corporate fraud offences.[583]

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[582] The type of relief or protection which is afforded under section 806 of the *Sarbanes-Oxley Act of 2002* includes reinstatement, back-pay or special damages. Relief may be awarded by the Secretary of Labour or a U.S. District Court.

[583] Canada, Department of Finance, *The Budget Plan 2003* (Ottawa: Queen's Printer, February 2003) at 184-187.

APPENDICES

APPENDIX A

GLOSSARY

1934 Act—the Securities Exchange Act of 1934, 15 U.S.C. §§ 78a et seq.

1990 Proposals—the set of proposals entitled Proposals for Amendments to the Securities Act (Ontario) in the Areas of Investigations, Enforcement and Remedies, (1990) 13 OSCB 405.

1994 Amendments—the *Securities Amendment Act, 1994*, S.O., c. 11, which gave the Ontario Securities Commission rulemaking power.

2002 Amendments—the Keeping the Promise for a Strong Economy Act (Budget Measures), 2002 (formerly Bill 198).

Act—the Securities Act (Ontario), R.S.O. 1990, c.S.5.

AcSB—the Canadian Accounting Standards Board.

AIF—annual information form.

Alberta Act—the *Securities Act* (Alberta), R.S.A. 2000, c. S-4.

Allen Committee—The Toronto Stock Exchange Committee on Corporate Disclosure established in June 1994 to review and comment on the adequacy of continuous disclosure by public companies in Canada and to determine whether additional remedies should be available to injured investors or regulators if companies fail to comply with the rules.

Allen Report—the report issued in March 1997 by The Toronto Stock Exchange on Corporate Disclosure entitled *Responsible Corporate Disclosure, A Search for Balance*.

Analysts Standards Committee—the Securities Industry Committee on Analysts Standards formed in 1999 by the IDA, TSX and TSX Venture Exchange.

AcSOC—the Accounting Standards Oversight Council.

ATS—alternative trading system.

Bank Act—the *Bank Act*, S.C. 1990, c. 46.

BCSC—the British Columbia Securities Commission.

Blue Ribbon Committee—the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees sponsored by the NYSE and the NASD at the request of the SEC.

British Columbia Act—the *Securities Act* (British Columbia), R.S.B.C. 1996, c. 418.

Bulletin—the Ontario Securities Commission Bulletin.

CBCA—the *Canada Business Corporations Act*, R.S.C. 1985, c. C-44.

CBO—the Canadian Banking Ombudsman.

CDN—the Canadian Dealing Network.

CDNX—the Canadian Venture Exchange Inc.

CD Team—the Continuous Disclosure Team of the Ontario Securities Commission.

CEO—chief executive officer.

CFO—chief financial officer.

CICA—the Canadian Institute of Chartered Accountants.

Civil Liability Amendments—the draft amendments published by the CSA proposing a statutory civil liability regime in CSA Notice 53-302 – Proposal for a Statutory Civil Remedy for Investors in the Secondary Market and Response to the Proposed Change to the Definitions of "Material Fact" and "Material Change" ((2000), 23 OSCB 7383).

Commission—the Ontario Securities Commission.

Committee—the Five Year Review Committee.

CSA—the Canadian Securities Administrators.

CUB—the Canadian Unlisted Board.

CVMQ—the Commission des valeurs mobilières du Québec.

Daniels Committee—the Joint Task Force on Securities Regulation established by the Ministry of Finance and the Ontario Securities Commission in October 1993 to review and make recommendations regarding the legislative framework for the development of securities policy in Ontario.

Daniels Report—the report by the Task Force on Securities Regulation, Responsibility and Responsiveness – Final Report of the Ontario Task Force on Securities Regulation (1994), 17 OSCB 3208.

Dey Committee—the TSE Committee on Corporate Governance in Canada established in September 1993 to conduct a study of corporate governance in Canada and to make recommendations to improve the manner in which Canadian corporations are governed.

Dey Report—the report issued by the Dey Committee in 1994 entitled *Where Were the Directors? Guidelines for Improved Corporate Governance*.

ECA—the *Electronic Commerce Act, 2000* (Ontario), S.O. 2000, c. 17.

FCAC Act—the *Financial Consumer Agency of Canada Act*, S.C. 2001, c. 9.

FSA—the Financial Services Authority of the U.K..

FSCO—the Financial Services Commission of Ontario.

GAAP—generally accepted accounting principles.

G-7—the group of seven countries consisting of the U.S., Japan, Germany, France, Italy, Britain and Canada.

IAS—international accounting standards promulgated by IASC.

IASC—the International Accounting Standards Committee.

IDA—the Investment Dealers Association of Canada.

IDS—the Integrated Disclosure System.

IFAC—the International Federation of Accountants.

IFIC—the Investment Funds Institute of Canada.

Insurance Act—the *Insurance Act*, R.S.O. 1990, c. I.8.

IOSCO—the International Organization of Securities Commissions.

Joint Forum—the Joint Forum of Financial Market Regulators which was established by the CSA, Canadian Council of Insurance Regulators and Canadian Association of Pension Supervisory Authorities and is made up of representatives of those organizations. Its goal is to co-ordinate and streamline the regulation of financial products and services across Canada.

Joint Forum Task Force on Dispute Resolution—the Task Force on Dispute Resolution created by the Joint Forum of Financial Market Regulators in Canada.

Kimber Report—the Report of the Attorney General's Committee on Securities Legislation in Ontario (Ontario: Queen's Printer, 1965).

LSUC—the Law Society of Upper Canada.

MFDA—the Mutual Fund Dealers Association.

MJDS—Multi-Jurisdictional Disclosure System.

MD&A—Management's Discussion and Analysis.

NASD—the National Association of Securities Dealers.

NASDAQ—the National Association of Securities Dealers Automated Quotations system.

NRD—National Registration Database.

NYSE—the New York Stock Exchange.

OBCA—the *Ontario Business Corporations Act*, R.S.O. 1990, c. B.16.

OSFI—the Office of the Superintendent of Financial Institutions.

QTRS—a Quotation and Trade Reporting System.

Quebec Act—the *Securities Act* (Quebec), R.S.Q. c. V-1.1.

Reformulation Project—the process began in 1994 by the Ontario Securities Commission to review all of its existing policy statements, notices and blanket rulings in order to either reformulate them as rules, policies or staff notices or eliminate them.

RS Inc.—Market Regulation Services Inc.

Saskatchewan Act—the *Securities Act* (Saskatchewan), R.S.S. 1988-89, c. S-42.2.

Saucier Committee—the Joint Committee on Corporate Governance sponsored in July 2000 by the TSX, TSX Venture Exchange and CICA, and chaired by Guylaine Saucier.

Saucier Report—the Final Report of the Joint Committee on Corporate Governance: *Beyond Compliance: Building a Governance Culture* (November 2001).

SEC—the U.S. Securities and Exchange Commission.

SEDAR—System for Electronic Document Analysis and Retrieval.

SEDI—System for Electronic Disclosure by Insiders.

SRO—self-regulatory organization.

TSE—The Toronto Stock Exchange (now known as the "TSX").

TSX—The Toronto Stock Exchange (formerly referred to as the "TSE").

TSX Guidelines—the guidelines in section 474 of the *TSX Company Manual for Effective Corporate Governance*.

TSX Venture Exchange—the TSX Venture Exchange and its predecessor, the Canadian Venture Exchange, or "CDNX."

UCC—the *Uniform Commercial Code*.

Wallman Report—the Report of the Advisory Committee on the Capital Formation and Regulatory Processes dated July 24, 1996.

Zimmerman Committee—the committee of the Investment Dealers Association of Canada established in 1996 to review take-over and issuer bid time limits.

LIST OF COMMENTERS ON DRAFT REPORT

1. Robert E. Lamoureux, PricewaterhouseCoopers
2. Michael Mackenzie
3. Power Corporation of Canada
4. Ontario Association of Unlisted Reporting Issuers (OAURI)
5. Patricia Cosgrove
6. Certified General Accountants of Ontario (CGA - Ontario)
7. Resolution Capital Inc.
8. FundSERV Inc.
9. Independent Financial Brokers of Canada (IFBC/CISFC)
10. Association for Investment Management and Research (AIMR)
11. New Democratic Party of Ontario
12. Small Investor Protection Association (SIPA)
13. Canadian Association of Insurance and Financial Advisors (CAIFA)
14. Fasken Martineau DuMoulin LLP
15. Robert Kyle
16. The Investment Funds Institute of Canada (IFIC)
17. Lawrence P. Schwartz
18. Ontario Teachers' Pension Plan
19. Canadian Investor Relations Institute (CIRI)
20. The Canadian Institute of Chartered Accountants (CICA)
21. Ken Kivenko
22. PricewaterhouseCoopers LLP
23. Nicholas LePan
24. Investment Counsel Association of Canada (ICAC)
25. Ogilvy Renault
26. Simon Romano (Stikeman Elliott)
27. BMO Nesbitt Burns

28. Canadian Bankers Association (CBA)
29. Office of the Superintendent of Financial Institutions Canada
30. Certified General Accountants Association of Canada (CGA)
31. Nova Scotia Securities Commission (NSSC)
32. Royal Bank of Canada
33. TSX Venture Exchange
34. Investment Dealers Association of Canada (IDA)
35. Gowling Lafleur Henderson LLP (Gowlings)
36. CBAO Securities Law Subcommittee
37. TSX
38. Davies Ward Phillips & Vineberg LLP
39. BCSC
40. Torys LLP
41. British Columbia Minister of Competition, Science & Enterprise
42. Canadian Capital Markets Association
43. Joint letter of Investment Dealers Association, Mutual Fund Dealers Association and RS Inc.

In addition, two comment letters were filed on a confidential basis.

ISSUES LIST

Five-Year Review Of Securities Legislation In Ontario -Securities Review Advisory Committee's Request For Comments

INTRODUCTION:

The Securities Act (Ontario) (the "Act") provides that, every five years, the Minister of Finance will appoint an advisory committee to review the legislation, regulations and rules relating to matters dealt with by the Ontario Securities Commission ("OSC" or the "Commission") and the legislative needs of the Commission. Finance Minister Ernie Eves has established the first such committee (the "Securities Review Advisory Committee" or the "Committee") to conduct this review. Minister Eves has directed the Committee, in discharging its mandate, to ensure that securities legislation in Ontario is up-to-date and that it properly enables the Commission to proactively enforce clear standards to protect investors and foster a fair and efficient marketplace. The full text of Finance Minister Eves' press release announcing the formation of the Committee is contained at Appendix 1 to this Request for Comments.

The Chair of the Committee is Purdy Crawford Q.C., counsel to Osler, Hoskin & Harcourt LLP. Other members of the Committee are Carol Hansell, partner with Davies, Ward & Beck; William Riedl, president and CEO of Fairvest Securities Corporation; Helen Sinclair, CEO of BankWorks Trading Inc; David Wilson co-chairman and co-CEO at Scotia Capital; and Susan Wolburgh Jenah, Commission general counsel. The Committee has retained Anita Anand, Assistant Professor, Faculty of Law, Queen's University and Janet Salter, lawyer with Osler, Hoskin & Harcourt LLP to assist the Committee in its review. They will be assisted by Rossana Di Lieto, Legal Counsel, Commission.

REQUEST FOR COMMENTS:

The Committee is seeking input from market participants in connection with its review of the legislation, regulations and rules relating to matters dealt with by the Commission. To stimulate input, the Committee has prepared an illustrative set of questions (the "Issues List") which it proposes to consider. The Issues List is published in the April 28, 2000 edition of the Ontario Securities Commission Bulletin and can be accessed at the Commission's website at www.osc.gov.on.ca.

The Issues List is intended as a catalyst for discussion only. Commenters are welcome to raise other matters that they believe fall within the Committee's mandate to consider. The Committee recognizes that certain matters may currently be under consideration by regulators or other entities but welcomes input on such matters as well.

By its very nature, the Issues List might give the impression that the Committee intends to recommend a more complex and comprehensive regulatory regime than currently exists. This is not the intention of the Committee. The Committee believes that it is necessary to find compelling public policy grounds to justify regulation. The Committee believes that where regulation is necessary, in many instances, self-regulation is desirable.

DRAFT REPORT:

The Committee proposes to prepare a report outlining the results of its consultation process and its recommendations. The report will be based in part on matters raised in the Issues List, but the Committee is not bound to address all items raised on the List, and may address other matters raised by commenters. The Committee will first publish the report in draft for comment.

COMMENTS:

Interested parties are invited to make written submissions with respect to the Issues List or other matters which commenters wish to raise. Submissions received by June 9, 2000 will be considered by the Committee. The following guidelines provide general information about making submissions to the Committee and the manner in which the Committee will handle the submissions.

Form of Submissions

Submissions should be sent in duplicate to:

Purdy Crawford
Osler, Hoskin & Harcourt LLP
Barristers & Solicitors
Box 50, 1 First Canadian Place
Toronto, Ontario M5X 1B8

A diskette containing the submissions should also be submitted.

All submissions should indicate a contact person and contact details (return address, telephone and fax numbers, e-mail address), who would be available to respond to inquiries from the Committee in connection with the submission.

Comment letters submitted in response to the Request for Comments will be placed on the public file and form part of the public record, unless confidentiality is requested. Since the Committee wishes to carry out its responsibilities in an open and accessible manner, requests for confidentiality are discouraged and should be limited to situations involving only highly confidential information where disclosure could be detrimental. Persons submitting comment letters should be aware that the press and members of the public may be able to obtain access to any comment letter, even if the Committee does not put the letter on the public file.

Consultation Process

The Committee does not intend to hold formal public hearings concerning the Issues List. Persons or entities making submissions may be approached by the Committee or its staff to expand upon their submissions or to enable Committee members to make further inquiries.

Dated: April 28, 2000.

Securities Review Advisory Committee Issues List

Commenters are encouraged to refer to the Commentary and Additional Questions (the "Commentary") attached to this Issues List for background information and elaboration on certain of the issues outlined below.

I. Principles Underlying Securities Regulation
  Fundamental Principles
  The Closed System

II. Focus and Scope of Legislation
  General
  Regulation of Registrants
  Self-Regulatory Organizations and Other Market Intermediaries
  Tiered-Holding System
  Continuous Disclosure Obligations
  Mutual Funds
  Shareholder Communications and Take-over Bids
  Enforcement

III. Impact of Regulatory Harmonization and Globalization Trends

IV. Impact of Technology

V. Mandate and Role of the Commission

I. PRINCIPLES UNDERLYING SECURITIES REGULATION

Fundamental Principles

1. Does the current statutory regime effectively balance the dual objectives of protecting investors and fostering efficient capital markets?

2. Securities regulation could be based on a statute that sets out broad principles and standards of market behaviour, as well as powers to deal with contravention of these standards. In this model, any detailed rules that might be required would be reflected in subordinate instruments, such as rules. Such a model would be flexible in its ability to adapt to market changes and trends. Is such a model desirable? If so, what broad principles and standards of market behaviour should be included in the legislation?

3. Does the Act[1] adequately account for the marketplace shift from trade execution towards "assets under management" and "advice giving"? Should these activities be regulated differently than they are now?

The Closed System

4. Is there a simpler approach that could replace the closed system but which would still protect investors, foster fair markets and maintain an appropriate balance between private and public offerings?

5. What exemptions from the prospectus and/or registration requirements of the Act should be added or removed?

6. Securities transactions are often artificially structured to avoid hold periods under the Act which result from the closed system. Should another approach be adopted to prevent sophisticated persons from being able to structure transactions to avoid control block restrictions?

7. The legending of security certificates to indicate and give notice of restrictions on resale is a concept that is incompatible with the holding of securities in book based form. In view of this reality, as well as the fact that securities are fungible, legends on certificates may not be transparent or effective. What alternatives exist, assuming the closed system continues in effect?

II. FOCUS AND SCOPE OF LEGISLATION

General

8. The regulation of financial services in Canada is structured around the nature of the institution (bank, insurance company, dealer) which is providing the service, rather than around the service itself. This has produced a rising number of circumstances where similar activities or products are regulated in a different fashion, depending on the nature of the financial conglomerate offering the product or service.

    a. Should securities regulation be amended to reflect the shift in the way financial markets are structured? For example, are the current exemptions from regulation of securities based on the issuer still appropriate?

    b. Should legislation include some formal requirement to facilitate the coordination between financial services regulators?

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[1] Securities Act, R.S.O. 1990, C. S.5.

9. Should financial services regulators, including self-regulatory organizations ("SROs"), have the ability to handle consumer complaints through ombudsman or arbitration schemes? If so, what type of complaint handling schemes would be desirable in Ontario?

10. Should the Act be integrated with the Commodity Futures Act[2] and the Commission be given explicit jurisdiction over derivatives?

Regulation of Registrants

11. Currently, securities legislation requires dealers to be registered when they "trade in securities in the capacity of principal or agent."[3] Rather than focusing on whether or not a dealer is "trading," should the requirement to be "registered" be based on whether the dealer is engaged in, or is holding itself out as being engaged in, the business of buying, selling or otherwise advising with respect to securities?

12. Largely as a result of the Internet and related technological developments, investors have direct access to the markets today.

    a. What is the role of an "intermediary" in the context of disintermediated markets? For example, are there activities or transactions that should be exempt from the need to involve a regulated intermediary? If so, what are they?

    b. To what extent do traditional obligations of registrants such as assessment of suitability and "know-your-client" need to be re-examined in the context of a disintermediated and electronic trading environment? In this context, do distinctions need to be drawn between registrants that are under a fiduciary obligation to their clients versus those that are not?

13. Should the concept of universal registration be eliminated? Alternatively, how might the current multiple categories of registration be simplified and streamlined?

Self-regulatory Organizations and Other Market Intermediaries

14. The Act recognizes the important role played by recognized SROs and establishes that the Commission should, subject to an appropriate system of supervision, rely on these SROs. In view of the critical role played by these recognized SROs:

    a. Should the legislation be more explicit in recognizing that SROs have the authority to enforce their own rules and ensuring that they have the necessary tools to do so?

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[2] R.S.O. 1990, Ch. c. 20.

[3] Subsection 1(1) Definition of "Dealer" and subsection 25(1).

b. Should recognized SROs have the authority and obligation to enforce compliance not only under their own rules but also Ontario securities law?

c. Should securities law permit or prohibit an SRO from acting as a trade association?

15. Currently stock exchanges are precluded from carrying on business in Ontario unless recognized by the Commission.[4] Should other SROs, clearing agencies, and quotation and trade reporting systems be required to obtain recognition from the Commission?

16. Does the Act need to address in a more comprehensive fashion the SRO regulatory oversight function and provide for the necessary tools to ensure that such oversight remains effective?

17. Should the provision of custody services be a registrable activity or be subject to express requirements under the Act?

Tiered-Holding System

18. Canadian law governing transfers and secured lending transactions involving investment securities relies upon concepts of possession and delivery of security certificates to complete a transfer or to perfect a pledge. The use of these concepts reflects an era when actual physical delivery of security certificates was the normal method of settling transactions and perfecting pledges. The concepts of actual or deemed possession and delivery work less well, however, when applied to the modern indirect holding system which now exists in Canada. How should Ontario and other Canadian provinces modernize laws that govern the holding, transferring and pledging of securities held through the indirect holding system? How closely should Article 8 of the U.S. Uniform Commercial Code ("Revised Article 8") be followed?[5]

Continuous Disclosure Obligations

General

19. In response to the increasing importance of the secondary markets, the Commission has taken action on a number of fronts as outlined in the Commentary.

a. Does the present structure of the Act adequately respond to the increasing importance of the secondary market? For example, a successful continuous disclosure monitoring system requires effective regulatory tools to deal with misleading or inappropriate disclosure practices to encourage issuer compliance. Are additional powers or remedies needed to facilitate the Commission's enhanced role in monitoring continuous disclosure?

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[4] Subsection 21(1).

[5] See Commentary 18, *infra*.

b. Are there any changes which should be made to the Act to improve the content, quality and timing of continuous disclosure?

c. Should there be statutory civil liability for misrepresentations in continuous disclosure documents?

Materiality

20. Securities legislation currently focuses on "material facts" and "material changes" for various purposes such as prospectus disclosure and continuous disclosure obligations, insider trading rules and proxy solicitation rules.

a. Is the existing standard of materiality for purposes of triggering continuous disclosure obligations appropriate?

b. Would a focus on "material information" be more appropriate regardless of whether or not there has technically been a "change" in the issuer's affairs?

c. Should Ontario securities law require the reporting of specified events rather than attempting to specify whether information meets a certain standard of materiality?

Financial Disclosure

21. The Act requires financial statements of reporting issuers to be prepared in accordance with generally accepted accounting principles (GAAP) and audited and reported upon in accordance with generally accepted auditing standards (GAAS).[6] The Act also provides the Commission with specific rulemaking powers with respect to the accounting and auditing standards to be applied in financial statements and auditors' reports filed with the Commission.[7] To date, the Commission has chosen not to exercise its rulemaking powers in any manner that overrides the standards set out in the CICA Handbook.

a. Are traditional GAAP/GAAS financial statements adequate in today's markets? For example, should the current accounting principles applicable to compensation options be reviewed to ensure that the accounting treatment of options conforms to standards of good corporate governance?

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[6] *Securities Act*, R.R.O. 1990, Regulation 1015, Section 2.

[7] Clause 143(1)25.

   b. What reforms should be adopted to facilitate uniform international accounting standards?

Selective Disclosure

22. Is the practice of "selective disclosure" an issue that should be addressed by regulation? If so, what regulation would be appropriate? Is the approach of the U.S. Securities and Exchange Commission (the "SEC") one that should be adopted?

23. How do concerns with respect to selective disclosure impact on traditional views with regard to "road show" presentations?

Mutual Funds

24. Are any reforms necessary under the Act to improve fund governance? Should there be a requirement for an independent board? If so, what responsibilities should be attributed to the board? What should the powers of the board be in the event it does not agree with management?

25. Should fund managers be regulated or be required to be registered?

26. As part of the proposal to introduce statutory civil liability for misrepresentations in continuous disclosure documents, the CSA is proposing to change the definition of "material change" when used in relation to mutual funds to parallel the definition of "significant change" in National Instrument 81-102 Mutual Funds.[*]

    Should this revised standard for mutual funds be reflected in the Act?

27. Since 1997, the CSA have been working with the Investment Dealers Association of Canada and The Investment Funds Institute of Canada to facilitate the establishment of a self-regulatory organization for distributors of mutual funds in Canada. Moreover, in May, 1998 the CSA promulgated rules governing mutual fund sales practices. More recently, the CSA published a position paper which sets out acceptable ways in which securities firms will be expected to structure themselves for the purposes of distributing

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[*] Under the draft legislation "material change" when used in relation to an issuer that is an investment fund, means,

(i) a change in the business, operations or affairs of the issuer that would be considered important by a reasonable investor in determining whether to purchase securities of the issuer, or in determining whether to continue to hold securities of the issuer, or

(ii) a decision to implement a change referred to in subparagraph (i) made,

   (a) by senior management of the issuer who believe that confirmation of the decision by the board of directors or such other persons acting in a similar capacity is probable, or

   (b) by senior management of the investment fund manager of the issuer who believe that confirmation of the decision by the board of directors of the investment fund manager of the issuer or such other persons acting in a similar capacity is probable.

securities to the investing public. Are there additional reforms that are necessary or desirable in the area relating to the distribution of investment funds?

Shareholder Communications and Take-over Bids

28. Proposed amendments to the Canada Business Corporations Act[9] have been introduced which are intended to encourage and facilitate communications among shareholders. The SEC has also amended its proxy rules to foster more open communication among shareholders.[10] Are there complementary reforms that are necessary or desirable under the Act or Business Corporations Act (Ontario)?[11]

29. Recently the Committee of the Investment Dealers Association of Canada to Review Take-Over Bid Time Limits (the "Zimmerman Committee") issued a report which recommended a number of changes in the regulation of take-over bids. Many CSA jurisdictions, including Ontario, have now enacted legislation, subject to proclamation, which would implement the recommendations of the Zimmerman Committee.[12]

    a. Are additional reforms necessary or desirable in the area of take-over bid or issuer bid regulation?

    b. Does the current legislation properly capture those transactions that should be subject to take-over bid regulation?

Enforcement

30. Are the current detection and disclosure provisions with respect to insider trading sufficient? Does the Commission need additional enforcement authority in dealing with insider trading?

31. Securities legislation in many jurisdictions includes fraud and market manipulation as specific contraventions against which securities regulators have the power to act. Should such offences be expressly included in the Act?

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[9] R.S.C. 1985, c C-44.

[10] Regulation of Communications Among Shareholders, 17 CFR Parts 240 and 249, Release No. 34-31326170 and Regulation of Takeovers and Security Holder Communications, 17 CFR Parts 200, 229, 230, 232, 239 and 240, Release No. 33-7760, 34-420055.

[11] R.S.O. 1990, c. B. 16.

[12] In Ontario, the amendments proposed by the Zimmerman Committee were included in the *More Tax Cuts for Jobs, Growth and Prosperity Act, 1999* which received Royal Assent on December 14, 1999.

III. IMPACT OF REGULATORY HARMONIZATION AND GLOBALIZATION TRENDS

32. While securities regulation continues to be administered provincially, there has been an increasing trend towards inter-provincial co-operation and harmonization in the administration of securities regulation across Canada.

    a. Is the mutual reliance review system an effective means of achieving inter-provincial co-operation and harmonization?

    b. Are there other areas of securities regulation where it would be beneficial to have a more "seamless" form of regulation between provincial securities regulators?

    c. Should the Act explicitly recognize the ability of the Commission, in appropriate circumstances, to delegate functions to other securities regulators in Canada or elsewhere?

33. Capital markets are becoming more international in character but regulation still exists only at the domestic level. The transnational nature of global trading has removed securities transactions from the full jurisdictional reach of domestic regulation. As discussed in the Commentary, this is an issue that the European Community has recently addressed. How does one ensure proper regulation from a domestic perspective without compromising global competitiveness for issuers and investors?

IV. IMPACT OF TECHNOLOGY

34. The Act is "paper-based" and is oblivious to the emergence of the Internet and E-commerce transactions. Are changes to the legislation necessary in view of technological developments for instance with respect to continuous disclosure obligations, insider trading reporting, prospectus offerings etc.?[13]

35. Is any new regulation required to address the use of the Internet as a means for issuers to communicate with their shareholders? For example, is regulation required to enable shareholders to vote online and similarly to receive on demand, or access from a central website, electronically-transmitted press releases and public filings?

36. The Internet has made it possible for issuers to sell shares directly to the public without the use of an underwriter. Direct purchase plans allow individuals to contribute through a monthly bank account debit to the purchase of an issuer's shares. In the U.S., Home Depot has currently adopted this practice. A simplified prospectus in plain English is online and incorporates by reference its annual and quarterly financial reports. If

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[13] *See NP 47-201 "Trading Securities Using the Internet and Other Electronic Means" (1999) 22 OSCB 8170.*

Canadian issuers begin to raise a portion of their financing in this way, should the Act and regulations be changed to account for this type of offering?

37. The current shareholder communication model reflected in the Act mandates that a reporting issuer "deliver" to security holders specific corporate information. In light of the communication opportunities presented by the Internet and the availability of corporate disclosure through SEDAR is this communication model still appropriate? For example, should securities regulators go further than National Policy 11-201 Delivery of Documents by Electronic Means[14] and shift the onus on to shareholders to request information, in the absence of which they will be deemed to have requested that such information not be delivered?

38. In the Internet age, determining the limits of jurisdiction raises significant issues relating to the scope of the Commission's jurisdiction. Do changes need to be made to the Act to address issues of extra-territoriality that arise in the context of disclosure, offerings and transactions completed on the Internet?

V. MANDATE AND ROLE OF COMMISSION

39. The Commission received rulemaking authority approximately five years ago.

    a. Is the rulemaking process an effective way of regulating?

    b. In light of recent experiences, are there changes that should be made to the rulemaking process? For example, should the Commission be granted flexibility and discretion when republication is warranted?

40. Are the current enforcement powers of the Commission appropriate?[15] Are there any additional enforcement powers that should be granted to the Commission?

41. Is the Commission's mandate as reflected in the legislation appropriate in today's market?[16] Should the Commission's mandate recognize the importance of securing Ontario's place within global and competitive securities markets?

42. The Act sets out "principles" for the Commission to consider in discharging its statutory mandate.[17] In today's market, are these principles appropriate, relevant and sufficient as bases on which the Commission should discharge its responsibilities?

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[14] *(1999) 22 OSCB 8156*. The substance and purposes of NP 11-201 is to state the views of the CSA on how obligations imposed by securities legislation to deliver documents can be satisfied by electronic means.

[15] Subsection 127(1) and Section 127.1.

[16] Section 1.1.

[17] Section 2.1.

Commentary And Additional Questions

Further explanation, examples and additional questions pertaining to matters raised in the Issues List are outlined below. The numbers of the items in this Commentary follow the numbering adopted in the Issues List.

I. PRINCIPLES UNDERLYING SECURITIES REGULATION

Fundamental Principles

3. The Act is structured to regulate "trades" and "distributions." Increasingly, however, revenue is gained not only from trade execution, but also from providing advice, unbundling services (i.e., advice, execution, clearing and settlement) and administering assets under management.

The Closed System

4. The closed system governs exempt distributions under the Act. Introduced in 1979, the system was in part intended to replace the concept of "distributions to the public." While the closed system introduced more certainty in the area of exempt distributions, it also introduced a level of complexity and lack of flexibility into the regulatory regime. A number of regulations and rules have been adopted to address the inevitable gaps as well as the overreaching impact of the system. In addition, the Commission has had to deal with a proliferation of applications for ad hoc relief from these requirements.

5. There have been several recommendations and proposals that have been made in an effort to better assist the capital-raising process. For example, the Final Report of the Task Force on Small Business Financing recommended recasting the current registration and prospectus exemptions.[18] More recently, Commission staff recommended adopting new categories of exemptions in place of the existing ones - see "Revamping the Regulation of the Exempt Market - A Concept Paper prepared by Staff of the Ontario Securities Commission."[19]

II. FOCUS AND SCOPE OF REGULATION

8. One example of the shift in the way financial markets are structured arises with respect to the number of exemptions in the Act available to various financial institutions for particular types of securities. However, the elimination of the "four pillars" has enabled issuers that offer substantially similar products to be regulated differently depending on which particular regulator governs the issuer.

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[18] (1996) 19 OSCB 5753.

[19] (1999) 22 OSCB 2829.

9. For example, the Investment Dealers Association (the "IDA") recently launched an arbitration process for disputes which cannot be resolved through regular administrative channels within the investment dealer. The process has been developed for Ontario resident clients of IDA member firms that are registered to undertake business in Ontario. The events in dispute must have originated after June 30, 1998 and the claimed amount must exceed $6,000 but cannot exceed $100,000, excluding costs. If the investor decides to utilize this process, the investment dealer is obliged to do so also.

The banking and life insurance sectors in Canada also provide consumer redress mechanisms. Since 1996, the Canadian Banking Ombudsman assisted in resolving complaints from small businesses about bank services. Its mandate was expanded in 1997 to encompass personal banking complaints. In 1998, the Canadian Life and Health Insurance Association introduced an ombudservice to provide informal conciliation for consumers with a complaint about a life insurance company. More recently, the Report of the Task Force on the Future of the Canadian Financial Services Sector (released on September 15, 1998) recommended that a legislated federal financial sector ombudsman should be established for customers of all financial institutions.

Finally, as part of ongoing regulatory reforms in the U.K. ("UK") the Financial Services Authority (the "FSA") is required to establish a single, compulsory ombudsman scheme for the speedy and informal resolution of disputes between members of the public and FSA-authorized firms.[20] The financial services ombudsman will replace the existing eight complaint-handling schemes and will be run by a separate company. The company will be legally and operationally independent of the FSA but will be required to report annually to the FSA on the discharge of its functions.

Regulation of Registrants

11. Registration for trading in securities in the capacity of principal or agent, or registration for being engaged in the business of buying, selling, or otherwise advising with respect to securities, will not capture the activity of all market participants who exert influence over decision-making in respect of the purchase of securities. For example, while portfolio managers must be registered as investment counsel/portfolio managers, and have completed stringent proficiency and experience requirements, equity research analysts, whose opinion often contributes to the investment decisions of portfolio managers, need

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[20] The FSA was created in October, 1997 to replace the Securities and Investments Board and will eventually absorb nine front line regulatory bodies (including the Securities and Futures Authority, the Insurance Directorate of the Department of Trade and Industry and the Personal Investment Authority) and have ultimate authority over all financial services in the U.K. The relevant legislation is the Financial Services and Markets Bill which is expected to receive Royal Assent later this year. Pending Royal Assent, the FSA has been operating under interim arrangements with the existing regulatory bodies. Effective June 1998, the FSA also took over responsibility for the supervision of banks, wholesale money markets and the foreign exchange clearing house, from the Bank of England.

not be registered and need not have complied with any proficiency or experience requirements.

12. In April, 2000 the CSA announced that relief from suitability and know-your-client obligations will be granted on an application basis to dealers who only provide trade execution services for clients. The relief is subject to the dealer complying with certain conditions including that it be an independent entity or unit which does not provide advice or recommendations; that its representatives not be compensated on the basis of transactional values; and that the client first provide written informed acknowledgement that no advice or recommendations will be given.

Self-Regulatory Organizations and Other Market Intermediaries

15. Part VIII of the Act prohibits any stock exchange from carrying on business in Ontario unless recognized by the Commission. However, with respect to SROs other than stock exchanges and with respect to clearing agencies and quotation and trade reporting systems, there is no mandatory recognition requirement. Moreover, the Act does not deal with central depositories and rating agencies. By contrast, in the U.S., central depositories and rating agencies are subject to explicit recognition and oversight by the U.S. Securities and Exchange Commission (the "SEC").

17. In 1997 the custody of investments (consisting of safeguarding and administration services) became an "authorisable" activity in the UK. More specifically under the Financial Services Act 1986, it is an offence to carry on custody business in the UK without being an authorised or exempted person. Among the reasons identified by the UK government for making custody an authorisable activity were the considerable risks for investors if the enormous amounts of assets held in custody were not properly controlled.

In particular, the UK government identified the following main hazards: (i) misappropriation through fraud; (ii) delivery otherwise than in accordance with authorised instructions; (iii) the improper use of one customer's investments to settle or secure another's obligations; (iv) failure to maintain adequate records identifying an individual customer's entitlement to, and the status of, investments; (v) unauthorised use of customers' investments for a firm's own purpose or commingling of customers' investments with a firm's investments in such a way as to place customers' investments at risk in the event of the firm's insolvency; and (vi) deficiencies in documentation such that the division of responsibilities in the event of loss as between a customer, an authorised firm and any third parties is unclear. Moreover with the dematerialization of securities there was a growing recognition that the role and responsibilities of custodians were becoming increasingly important yet less clear in law.[21]

Tiered-Holding System

18. Current Canadian law governing transfers and secured transactions involving securities and other financial products is found in various federal and provincial corporate statutes, federal legislation governing financial institutions, such as the federal Bank Act, Bills of Exchange Act, Depository Bills and Notes Act and provincial personal property security acts.

In the indirect holding system, in the case of registered securities, the beneficial owner is not shown on the issuer's records. In the case of unregistered securities such as bearer bonds, the beneficial owner does not have actual possession of a negotiable certificate. Instead, the securities are registered or in the possession of a securities depository/clearing agency such as the Canadian Depository for Securities. The records of the depository evidence the securities held on behalf of its various participant brokers, banks and trust companies. The records of each participant show the securities held on behalf of their individual customers (typically, the beneficial owners).

In 1994, Article 8 of the U.S. Uniform Commercial Code was revised ("Revised Article 8"). The objective of Revised Article 8 was not to change securities holding practices, but to provide a clear and certain legal foundation for the indirect holding system. The approach was to reform the rules to more accurately describe the special property interest of one who holds a book-entry security position through an intermediary. Revised Article 8 defines a relationship between an intermediary and entitlement holder by establishing a package of rights and obligations called "security entitlements" which is itself a unique form of property interest and not merely a personal claim against an intermediary.[22]

In early 1998, the CSA established a task force whose mandate is to develop a uniform set of Canadian settlement rules and secured lending rules. The intention is for the Canadian rules to be harmonized with Revised Article 8.

Continuous Disclosure Obligations

General

19. In January 1999, the Commission created a Continuous Disclosure Team which is responsible for monitoring and assessing the continuous disclosure record of reporting

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[21] The Securities and Investments Board, Consultative Paper 90, *Custody* (August 1995).

[22] See Eric Spink, Uniform Law Conference of Canada, *Report of the Production Committee*, Tiered Holding System - Uniform Legislation Project *(April 30, 1997)*.

issuers. The Continuous Disclosure Team intends to review the continuous disclosure record of all reporting issuers in Ontario on a periodic basis through a combination of targeted and random reviews.

In January 2000, the Commission, together with other members of the CSA, published for comment a concept paper relating to the proposed Integrated Disclosure System.[23] The Integrated Disclosure System would integrate the information which reporting issuers are required to provide to investors in both the primary and secondary markets. The goal is to make it simpler for companies to access the market while providing enhanced disclosure for investors. The foundation of the system would be an upgraded "continuous disclosure base" that offers the public information relating to an issuer and its business. The information would be comparable to the information that is currently provided in a prospectus.

More recently, the Commission published for comment two proposed rules that will upgrade current quarterly reporting requirements. Proposed Rule 52-501, Financial Statements, introduces a new requirement for all public companies to include in interim financial statements an income statement and a cash flow statement for the current quarter in addition to the currently required year to date information.[24] Companies will also be required for the first time to provide an interim balance sheet and explanatory notes to the interim financial statements. A company's board of directors and its audit committee will be required to review the interim financial statements before they are filed with the Commission and distributed to shareholders. The proposed Companion Policy urges Boards, in discharging their responsibilities for ensuring the reliability of interim financial statements, to consider retaining external auditors to conduct a negative assurance review.

Proposed Rule 51-501 reformulates existing OSC Policy 5.10 and introduces a new requirement for management to provide a narrative discussion and analysis (MD&A) of interim financial results with the interim financial statements.[25] This will enable investors to gain an understanding of past corporate performance and future prospects on a more timely basis. The proposed Rule will replace OSC Policy 5.10 and give the Commission greater ability to enforce compliance with annual and interim MD&A content requirements.

On May 29, 1998 the Commission and other members of the CSA published for comment proposed legislative amendments to the Act which would result in the creation of a limited statutory civil liability regime enabling investors that purchase securities in the secondary markets to bring a civil action against issuers and other responsible parties for misrepresentations in disclosure documents and other statements relating to the issuer or its securities (the "Proposal").[26] The Proposal arose out of the CSA's review and support of the Final Report of the Toronto Stock Exchange Committee on Corporate Disclosure (the "Allen Committee") issued in March, 1997.[27] The Allen Committee was established to review continuous disclosure by public companies in Canada and assess the adequacy of such disclosure. The Allen Committee was also asked to consider whether additional remedies ought to be available, either to regulators or to investors, if companies fail to observe the rules.

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[23] (2000) 23 OSCB 633.

[24] (2000) 23 OSCB 1793.

[25] (2000) 23 OSCB 1783.

Materiality

20. CSA National Policy Statement No. 40 ("NP40") and the TSE's Timely Disclosure Policy (the "TSE Policy") are examples of attempts to expand the current concepts of materiality. In November 1997, the Commission published for comment a proposal to amend the definitions of "material fact" and "material change" that would significantly alter the standard of materiality.[28] Under the proposed new standard, facts or changes would be "material" if "substantially likely to be considered important to a reasonable investor in making an investment decision." Neither the Commission nor CSA has pursued these changes.

The Allen Committee reviewed the distinction between a "material change" and "material information." The Allen Committee concluded that the distinction was "an exercise in sophistry" but had practical implications insofar as issuers are bound by law to disclose "material changes" and not "material information." In its interim report, the Allen Committee concluded that NP40 and the TSE Policy are examples of successful attempts to expand current concepts of materiality.[29] They recommended that material change reporting obligations should be triggered not only when material changes occur but also when material information comes to light. The May 1997 Final Report of the Allen Committee did not refer to these recommendations in the Interim Report.

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[26] "Civil Liability for Continuous Disclosure" (1998) 21 OSCB 3367.

[27] The Toronto Stock Exchange Committee on Corporate Disclosure, Final Report, *Responsible Corporate Disclosure - A Search for Balance* (March 1997).

[28] *OSC Request for Comment 51-901: "Material Fact and Material Change" (1997) OSCB 5751.*

[29] The Toronto Stock Exchange Committee on Corporate Disclosure, Interim Report, *Toward Improved Disclosure - A Search for Balance in Corporate Disclosure* (December 1995).

Financial Disclosure

21. As noted above in commentary 19, the Commission has recently released for comment two rules which will upgrade current quarterly reporting requirements. Under the rules, interim financial statements would be required to include a balance sheet and enhanced note disclosure. Quarterly MD&A would have to be provided; boards of directors, and audit committees where they exist, would be required to review interim financial statements before they are sent to shareholders.

In the U.S., concern about corporate audit practices prompted the SEC to appoint a blue-ribbon panel to determine ways to improve the effectiveness of audit committees. The panel's report, released in 1999, outlined a 10-point plan that included a revised definition of what constitutes an independent director, requirement of an independent audit committee for large listed companies, and criteria governing the size, responsibilities, and financial literacy of audit committees. The Financial Accounting Standards Board in the U.S. has also proposed eliminating the ability of issuers to use "pooling of interests" accounting principles.

In 1999 the International Accounting Standards Committee ("IASC") completed its work in the development of a core set of international accounting standards for international use. Presently, the International Organization of Securities Commissions is undertaking an assessment of the acceptability of these standards. Since the IASC standards are copyrighted, we have not reproduced them as part of this notice. However, summaries of the IASC standards are available from the IASC website at www.iasc.org.uk.

Selective Disclosure

22. Recently, the SEC proposed new rules for comment to address the practice commonly known as "selective disclosure."[30] The SEC's proposed Regulation FD ("Fair Disclosure") provides that if an issuer, or any person acting on its behalf, discloses material non-public information to any other person, the issuer must simultaneously (for intentional disclosures) or promptly (for non-intentional disclosures) make public disclosure of that same information.

The Allen Committee also addressed "equality of access" issues in both its Interim and Final Reports. The Allen Committee made a number of recommendations designed to equalize access of information among investors and prevent selective disclosure of material information. In particular it recognized that the regulatory concern relating to selective disclosure is that "access to better information - let alone to material undisclosed information - represents an inequality of access between retail and institutional investors."

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[30] Selective Disclosure and Insider Trading, *Release Nos. 33-7787, 34-42259, IC-24209, File No. S7-31-99 (December 20, 1999).*

Mutual Funds

24. In her report concerning the investment funds industry (the "Stromberg Report"),[31] Glorianne Stromberg made numerous recommendations relating to the operation and regulation of mutual funds in Canada. One of her recommendations was that investment funds should be required to have an independent board of directors.[32] In its response to the Stromberg Report, the Investments Funds Steering Group agreed with the recommendation, suggesting that each fund family should have a board of at least five members, the majority of whom are independent of the manager and an audit committee comprised entirely of independent members of the board.[33]

Rules in the U.S. currently require boards of directors for investment funds. Recently the SEC has proposed amending the rules to require that: at least half and up to two-thirds of a fund's directors be independent; and that boards have better access to legal counsel unaffiliated with the fund.

25. The Stromberg Report recommended registration of mutual fund managers.[34] The Investment Funds Steering Group felt that matters relating to the governance of fund managers as corporate entities should be left to applicable existing corporate and securities laws.[35]

Shareholder Communications and Take-over Bids

Proxy Rules

28. The SEC amendments permit communications among shareholders at the following times: before the filing of a registration statement relating to a take-over transaction; before the filing of a proxy statement (regardless of the subject matter or contested nature of the solicitation); and regarding a proposed tender offer without "commencing" the offer and requiring the filing and dissemination of specified information.

In Canada, proponents of this approach argued before the Senate Committee reviewing proposed changes to the Canada Business Corporations Act that continued, informal communication amongst shareholders would foster a higher quality of corporate governance and enable better communication among institutional investors.[36]

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[31] *Regulatory Strategies for the Mid-'90s - Recommendations for Regulating Investment Funds in Canada* (January 1995).

[32] *Ibid., pp. 147 - 154.*

[33] Investment Funds Steering Group, *The Stromberg Report: An Industry Perspective* (November 1996), p. 50.

[34] Stromberg Report, pp. 87 – 90.

[35] Investment Funds Steering Group, p. 50 fn. 29.

Take-over Bids

29. For example, the Commission des valeurs mobilières du Québec has advised in a Notice that it will be asking the CSA Take-Over Bid Committee to consider whether the take-over bid provisions should be extended to transactions which are not structured as take-over bids but which achieve the same result, such as arrangements.[37]

Enforcement

Insider Trading

30. The use of structured products allows insiders to dispose of economic interests in their securities without disposing of the securities themselves (thereby possibly avoiding insider trading rules). Such products also enable an insider to structure a transaction to deal with his or her holdings without necessarily triggering control block or escrow rules. Should these types of transactions be regulated?

Securities Fraud

31. For example, are additional powers needed to deal with "pump and dump" behaviour?[38]

III. IMPACT OF REGULATORY HARMONIZATION AND GLOBALIZATION TRENDS

32. Recent examples of the trend towards inter-provincial co-operation and harmonization in the administration of securities regulation across Canada include the establishment of the Canadian Securities Regulatory System; the increasingly important role played by the CSA (an informal association representing the Chairs of each of the provincial securities regulators); and the adoption of mutual reliance initiatives. More specifically, the CSA have adopted (or are developing) a mutual reliance review system for filings of prospectuses and AIFs for mutual fund and other issuers; continuous disclosure filings by issuers; applications for discretionary relief; and applications for registration of advisers and members of SROs.[39]

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[36] *Report of The Standing Senate Committee on Banking, Trade and Commerce, Corporate Governance* (August 1996).

[37] Bulletin hebdomadaire 2000-02-11 Vol. XXXI no. 06, pp. 4 - 5.

[38] In the classic "pump and dump" scheme, promoters artificially inflate a stock's price by making false claims about the issuer and by using high-pressure sales tactics to lure investors. After a substantial increase in the share price, the promoters and sometimes the insiders of the issuer take their profits and the stock price plummets.

[39] (1999) 22 OSCB 7293.

33. For example, as part of its 1992 common market program, the European Community (the "EC") adopted the Investment Services Directive (the "ISD"). Among other things, the ISD grants authorisation to EC investment firms to conduct cross-border operations anywhere in the EC either by physical presence (e.g. branch) or by remote access (i.e., electronic trading) based on a license issued by their respective home states.[40] In return for safeguarding the basic right to branch into or deal across borders with persons in other European member states, investment firms throughout the EC will be subject to certain minimum authorisation requirements and ongoing supervision. Is the European model an appropriate solution for Canada?

V. MANDATE AND ROLE OF THE COMMISSION

39. For example, under the Act, the Commission is required to republish for comment a proposed rule where the Commission proposes "material changes" to the original rule proposal that was published for comment.[41] This requirement has often led to multiple republications of proposed rules and significant time delay. By contrast, SEC proposals are not subject to a second (or subsequent) comment period provided that the final rule is a "logical outgrowth" of the rulemaking proceeding when viewed in light of the original proposal and call for comments.

40. Many securities regulators in Canada and globally have the power to levy monetary penalties. Should the Commission have such an enforcement power? Moreover, should the number of public interest orders that the Commission can make be expanded to include some of the orders that a court can make under section 128(3) of the Act? For example, should the Commission have the power to make a compliance order as set out under subsection 128(3)1? Similarly, should the Commission have the power to order that a registrant repay to its clients all or any part of the money paid by the client for securities purchased through the registrant where the registrant has behaved inappropriately in that context?

41. The mandate of the Commission is to: (a) provide protection to investors from unfair, improper or fraudulent purposes; and (b) foster fair and efficient capital markets and confidence in capital markets. In the UK, under the Financial Services and Markets Bill, the statutory objectives of the FSA are to: (i) maintain market confidence; (ii) promote public awareness; (iii) protect consumers; and (iv) reduce financial crime.

42. It is useful to note guiding principles that have been proposed or enacted with respect to other administrative bodies. In the UK under the Financial Services and Markets Bill, the

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[40] Investment services include brokerage, dealing as principal, market making, portfolio management, underwriting, investment advice, safekeeping and administration.

[41] Subsection 143.2(7).

FSA in pursuing its statutory objectives must have regard to (i) the need to use its resources in the most efficient and economic way; (ii) the responsibilities of those who manage the affairs of authorized persons; (iii) the principle that restrictions imposed on firms and markets should be in proportion to the expected benefits for consumers and the industry; (iv) the desirability of facilitating innovation in connection with regulated activities; (v) the international character of financial services and markets and the desirability of maintaining the competitive position of the UK; (vi) the need to minimize the adverse effects on competition that may arise from any exercise of its general functions; and (vii) the desirability of facilitating competition between those who are subject to any form of regulation by the FSA.

The Australian Securities and Investments Commission ("ASIC") enforces and administers Corporations Law and consumer protection law for investments, life and general insurance, superannuation and banking (except lending) throughout Australia. The ASIC has the function of monitoring and promoting market integrity and consumer protection in relation to the Australian financial system, the provision of financial services, and the payment system. In performing its functions and exercising its powers, the ASIC must strive to: (i) maintain, facilitate, and improve, the performance of the financial system and the entities within that system in the interests of commercial certainty, reducing business costs, and the efficiency and development of the economy; (ii) promote the confident and informed participation of investors and consumers in the financial system; (iii) achieve uniformity throughout Australia in how the Commission and its delegates perform those functions and exercise those powers; (iv) administer the laws that confer functions and powers on it effectively and with a minimum of procedural requirements; (v) receive, process, and store, efficiently and quickly, the information given to the Commission under the laws that confer functions and powers on it; (vi) ensure that information is available as soon as practicable for access to the public; and (vii) take whatever action it can take, and is necessary, in order to enforce and give effect to the laws that confer functions and powers on it.[42]

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[42] *Australian Securities and Investments Commission Act, 1989*, subsection 1(2).

Appendix 1 [to Issues List]

Advisory Committee Appointed To Review Securities Law

Ministry of Finance News Release - TORONTO, March 2 /CNW/ - Finance Minister Ernie Eves announced he has established an Advisory Committee to review the province's securities legislation. The Committee's mandate is to ensure the legislation is up-to-date and enables the Ontario Securities Commission to aggressively and proactively enforce clear standards to protect investors and foster a fair and efficient marketplace.

"Securities regulation that is firm, fair and effective instills investor confidence which is fundamental to economic growth and job creation," Eves said.

The committee will be chaired by Purdy Crawford Q.C., counsel to Osler, Hoskin & Harcourt, former chairman of Imasco and chairman of AT&T Canada. Other committee members are Carol Hansell, a partner with Davies, Ward & Beck; William Riedl, president and CEO of Fairvest Securities Corporation; Helen Sinclair, CEO of BankWorks Trading Inc; David Wilson co-chairman and co-CEO at Scotia Capital; and Susan Wolburgh Jenah, OSC general counsel.

Minister Eves extended his personal thanks to each of the committee members for agreeing to participate. "This is a group of highly qualified individuals who will bring to the table a depth of knowledge and diversity of perspectives," Eves said.

As a result of the Securities Amendment Act, 1994, the government is required to review the legislation, regulations and rules relating to matters dealt with by the Ontario Securities Commission every five years.

Purdy Crawford Q.C., is counsel to the law firm of Osler, Hoskin & Harcourt, former chairman of Imasco and chairman of AT&T Canada. A Harvard Law graduate, and member of the Ontario Bar, Mr. Crawford has received a number of honours including Officer of the Order of Canada and Honorary Doctorates of Laws from Mount Allison University and Dalhousie University. Mr. Crawford is chancellor of Mount Allison University and a director of a number of public companies in Canada and the U.S.. Mr. Crawford has agreed to chair the Advisory Committee.

Carol Hansell, is a partner with the law firm Davies, Ward & Beck specializing in corporate finance and securities, as well as mergers and acquisitions. Ms. Hansell has written a number of papers, articles and commentaries on a variety of corporate governance topics and is the author of Directors and Officers in Canada: Law and Practice.

William Riedl is the president and CEO of Fairvest Securities Corporation, an institutional stock brokerage firm specializing in matters of corporate governance and shareholder rights. He is also a director of the Investment Dealers Association of Canada.

Helen Sinclair is CEO of BankWorks Trading Inc. She was president of the Canadian Bankers Association from 1989 to 1996, and prior to that senior vice president and general manager, planning and legislation for Bank of Nova Scotia. Ms. Sinclair is a governor of York University, past chair of the YMCA of Greater Toronto, and a director of a number of public companies including TD Bank and Stelco.

David Wilson is the co-chairman and co-CEO at Scotia Capital and has an extensive background in corporate finance. Mr. Wilson is a past chairman of the Investment Dealers Association of Canada, and a director of a number of companies, including Rogers Communications Inc.

Susan Wolburgh Jenah is the general counsel for the Ontario Securities Commission, responsible for providing general legal and policy advice and project management support to both the Commission and staff. Ms. Jenah joined the Commission in August 1983 and has held various positions.

APPENDIX D

LIST OF COMMENTERS ON ISSUES LIST

1. John Palmer,
   Superintendent of Financial Institutions Canada
2. Smith Lyons
3. James C. Baillie
4. Dina Palozzi,
   Chief Executive Officer and Superintendent of Financial Services
   Financial Services Commission of Ontario
5. Mr. Larry Schwartz, by email (requesting confidentiality)
6. Investment Counsel Association of Canada
7. The Investment Funds Institute of Canada
8. PricewaterhouseCoopers
9. Canadian Securities Institute
10. KPMG LLP
11. BCSC
12. The Canadian Depository for Securities Limited
13. Glorianne Stromberg
14. Investment Dealers Association of Canada
15. Canadian Institute of Chartered Accountants
16. Canadian Association of Insurance and Financial Advisors
17. Torys LLP
18. Canadian Bankers Association
19. Ontario Teachers' Pension Plan Board
20. Alberta Securities Commission

21. Canadian Investor Relations Institute
22. Canadian Venture Exchange
23. Simon Romano, Stikeman Elliott (Personal Comments)
24. Osler, Hoskin & Harcourt LLP
25. CBAO Securities Law Subcommittee
26. Nancy Ross
27. Montreal Exchange
28. Aur Resources Inc.
29. Take-Over Bid Team at the Ontario Securities Commission
30. Small Investor Protection Association
31. Torys LLP – James E. A. Turner

In addition, one comment letter was filed on a confidential basis.

APPENDIX E

PRESENTERS TO COMMITTEE ON ISSUES LIST

1. Canadian Institute of Chartered Accountants

2. Michael Lauber, Canadian Banking Ombudsman

3. Joe Oliver, Executive Director
   Keith Rose, Vice-President, Regulatory Policy
   Investment Dealers Association of Canada

4. Phil Anisman

5. IFIC

ONTARIO SECURITIES COMMISSION STAFF PRESENTATIONS TO COMMITTEE ON ISSUES LIST

1. Randee Pavalow
   Tracey Stern
   Re: Alternative Trading Systems

2. Stan Magidson
   Janet Holmes
   Terry Moore
   Naizam Kanji
   Re: Take-over bids

3. Michael Watson
   Johanna Superina
   Hugh Corbett
   Greg Ljubic
   Re: Enforcement

4. Max Pare
   Re: Tiered Holdings Project

5. Julia Dublin
   Randall Powley
   Re: Re-Regulation of Advice Project

6. John Carchrae
   Re: Accounting Matters

7. Christopher Byers
   Re: Globalization

LESSONS FROM AUSTRALIA

In trying to address the feasibility of creating a national securities regime in Canada, we considered the historical development of Australia's current system of securities regulation.

By way of background, the Australian constitution, as in Canada, provides for the division of powers between the States and the federal Commonwealth Government. Section 51(xx) of the Australian constitution gives the Commonwealth Government the power to legislate with respect to "foreign corporations, and trading or financial corporations formed within the limits of the Commonwealth." Each State and Territory, on the other hand, has power under its own constitution to make laws for the "peace, order and good government" of that State and Territory.

Prior to 1970, corporate law (and securities regulation) in Australia was administered by individual States and Territories. In 1961, in response to frustrations expressed by market participants regarding the problems of doing business with six different legislative regimes and recognizing the existence of the national character of the Australian economy, the States and Territories passed uniform corporate legislation, similar to the U.S. Commercial Code. In time, however, differences among the States' and Territories' enactments emerged due to amendments of the legislation on a state-by-state basis.[1]

In 1970, in the wake of several financial scandals, a select senate committee was formed to consider the Australian securities industry. The Rae Committee, as it came to be known, released a report in 1974 which detailed findings of numerous unfair practices and criticized the various State and Territorial legislators for their inadequate performance in regulating the securities markets.[2] The committee recommended that a Commission similar to the U.S. Securities and Exchange Commission be established to oversee and regulate the securities market since the national character of the securities industry in Australia made State regulation inappropriate.[3]

In 1978, as an alternative to direct Commonwealth legislation, the Australian Commonwealth entered into an inter-governmental agreement with the States and Territories to create a co-operative scheme for regulating securities markets in Australia. The new scheme consisted of three administrative tiers. At the top was a Ministerial Council, a body consisting of one minister from each state and territorial government as well as one Commonwealth minister. Directly below was a newly created body, the National Companies and Securities Commission (NCSC), designed as the central administrator of the scheme. Finally, each State and Territory maintained a Corporate Affairs Commission (CAC) to perform the bulk of administrative duties under the scheme. Under the scheme, the Commonwealth passed companies and securities legislation for Australia's federal jurisdiction, and each state and territory, through local legislation, applied the federal legislation by reference.[4]

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[1] Paul von Nessen, *The Americanization of Australian Corporate Law*, 26 Syracuse Journal of International Law and Commerce 239.

[2] Jeffery Lehman, *The Bre-X Stock Debacle: Why the Enactment of Canadian Federal Securities Legislation Would be Good as Gold*, 24 Brooklyn Journal of International Law 823.

[3] Alan Shaw and Paul von Nessen, *The Legal Role of the Australian Securities Commission and The Australian Stock Exchange*.

While the co-operative scheme was successful in establishing uniform companies regulation throughout Australia, it was plagued by problems and was unable to adequately fill the void in Australia's company and securities legislation. In particular, the co-operative scheme suffered from a lack of uniform administration by the State Corporate Affairs Commissions; lack of accountability; and duplication of functions between the State Corporate Affairs Commissions and the National Companies and Securities Commission (NCSC).[5] Moreover, there were general concerns about the need for more effective national enforcement. In particular, under the scheme, the NCSC could not initiate prosecutions or interfere in enforcement at the state or territorial level. Finally, Australia's securities exchange industry was consolidating, culminating in April 1987 with the establishment of one national stock exchange.

Growing dissatisfaction with the ineffectiveness of the NCSC to properly enforce corporate law led to an inquiry by a select senate committee. In a report released in May 1987, the senate committee, acknowledging the problems with the cooperative scheme, concluded that the cooperative scheme should be replaced by comprehensive national legislation and that a single agency charged with administering such legislation should be established. In May 1988 in response to the criticisms of the cooperative scheme, the Australian Commonwealth government asserted power to enact legislation covering the entire legislative field relating to corporations and securities. The federal legislation established the Australian Securities Commission (the "ASC") as the sole administrative authority of corporate and securities law throughout Australia. State and territorial corporate authorities were to have no further authority in areas of regulation delegated to the ASC, although the ASC was required to establish a regional office in each Australian state and territory.

In time, certain aspects of the federal legislation were challenged by several states and were subsequently held to be invalid by Australia's High Court.[6] The High Court's decision meant that comprehensive nation wide companies and securities legislation was impossible without co-operation between the Commonwealth, the States and Territories. Accordingly in 1990, the Commonwealth, States and Territories entered into an agreement under which national legislation was enacted to deal with the entire field relying on combined Commonwealth and State and Territorial powers. Under the agreement:

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[4] *Supra.*, note 1.

[5] Ian Ramsay, *The Unravelling of Australia's Federal Corporate Law* (https://cclsr.law.unimelb.edu.au/Bulletins/Bulletin0031.htm).

[6] See *New South Wales v. Commonwealth* (1990) 169 CLR 482, where the Australian high court held that the constitution did not confer on the Commonwealth Government power to deal with the incorporation of companies. Only the state and territorial governments have this power.

1. ASC (now the Australian Securities and Investments Commission) was established as the national regulator to assume full responsibility for the regulation of companies. ASC replaced the State CAC and the NCSC. ASC was responsible and accountable to the relevant Commonwealth Minister and the Commonwealth Parliament.

2. The Commonwealth would amend its federal legislation so that it would apply in the Australian Capital Territory. Each State and Territory would then apply such federal law as a law of its jurisdiction.

3. Each state and territory was to legislate so as to require courts and others to treat the applied law as if it were a law of the Commonwealth. For example, the Federal Court was given power to hear matters arising under the State statutes and the investigation and prosecution of offences under the various State statutes would be undertaken by ASC and federal prosecutors.

4. The Ministerial Council was to continue but under new arrangements giving the Commonwealth more power, the Commonwealth Attorney-General becoming the permanent chair. The Council would have no control over the ASC.

5. Proposals for new legislation were to be considered by the Council. The Commonwealth when introducing them into Commonwealth Parliament was to table the Council's advice. However, legislative reform on national markets (take-overs, securities, public fundraising and futures) was to be the sole responsibility of the Commonwealth. Other proposals were to be approved by the Council before introduction into the Commonwealth Parliament. But the Commonwealth was not obliged to introduce any proposal of which it did not approve. On such matters the Commonwealth was to have four votes, each state and territory having one vote. The Commonwealth was given a casting vote.

Any amendments that the Commonwealth Government made to its statute would automatically apply in each of the States and Territories without the need for the State and Territorial Parliaments to pass further amendments.